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American Institute of Certified Public Accountants. Investment Companies Special Committee

Audit and Accounting Guide

AUDITS of INVESTMENT COMPANIES

With Conforming Changes As of May 1, 1992

AICPA
American Institute of Certified Public Accountants

Audit and Accounting Guide

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This edition of the audit and accounting guide *Audits of Investment Companies* has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the guide was originally issued. The changes made are identified in a schedule in Appendix I of the guide. The changes do *not* include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

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NOTICE TO READERS

This audit and accounting guide presents recommendations of the AICPA Investment Companies Special Committee on the application of generally accepted auditing standards to audits of financial statements of investment companies. This guide also presents the committee's recommendations on and descriptions of financial accounting and reporting principles and practices for investment companies. The AICPA Accounting Standards Executive Committee and members of the AICPA Auditing Standards Board have found this guide to be consistent with existing standards and principles covered by Rules 202 and 203 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from this guide.

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Preface

Applicability

This audit and accounting guide has been prepared to assist independent auditors in auditing and reporting on financial statements of investment companies. The guide describes operating conditions and auditing procedures unique to the industry and illustrates the form and content of investment company financial statements and related disclosures. Chapter 1 discusses the kinds of companies considered to be investment companies and to which the procedures in this guide apply.

Because many investment companies are subject to regulation under the Investment Company Act of 1940, rules under that Act are discussed extensively in this guide. However, the rules, regulations, practices, and procedures of the investment company industry have changed frequently and extensively in recent years. The independent auditor should keep abreast of those changes as they occur.

Changes in Accounting and Reporting Practices

Some of the recommended accounting and reporting practices in this guide differ from practices currently followed by investment companies. Following are summaries of the recommendations that differ significantly from current accounting and reporting practices:

- Tax-free business combinations of investment companies should be accounted for by a single method as described in chapter 8. Until now, two methods, the purchase method and the continuing entity (pooling) method, were used to account for business combinations of investment companies. Those methods should no longer be used.
- The illustrative financial statements have been modified to reflect some of the requirements of the SEC's revision of Regulation S-X. The most notable change is the adoption of an all-inclusive statement of operations. Though that statement represents current industry practice, it differs from the statement illustrated in the 1973 guide.
- Dividends declared on short securities should be treated as an expense, not as a reduction in investment income.
- The wording of the independent auditor's report has been revised for various matters, including a clarification of the wording in an auditor's report that is modified because of an uncertainty as to the values of portfolio securities.

Although this guide suggests certain audit procedures, it does not include detailed audit programs or internal control questionnaires. The guide does not describe all auditing procedures necessary to perform an audit in accordance with generally accepted auditing standards; it is only a guide in determining the scope of the work for each individual audit. It is not intended to limit or supplant individual judgment, initiative, imagination, or vigilance. Programs for each audit should be designed to meet its particular requirements, considering the size and kind of organization and the adequacy of internal control. Those matters should be determined only by the exercise of professional judgment based on particular circumstances.

Implementation

The effect of accounting changes caused by implementing this audit guide, notably the change in accounting for business combinations, should be applied prospectively.

Acknowledgments

The Investment Companies Special Committee has enjoyed the cooperation and substantive contributions of committees of the Investment Companies Institute and the American Bar Association. It has also had the benefit of comments from many individuals in the industry and on the staff of the Securities and Exchange Commission. The committee expresses its sincere appreciation for the significant contributions made by those committees and individuals to the preparation of this guide.

Investment Companies Special Committee

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Chapter 1

The Investment Company Industry

1.01 An investment company, as used in this guide, generally is an entity that pools shareholders' funds to provide the shareholders with professional investment management.[1] Typically, an investment company sells its capital shares to the public, invests the proceeds—mostly in securities—to achieve its investment objectives, and distributes to its shareholders the net income and net gains realized on the sale of its investments.

1.02 The investment company industry is highly specialized, intensely competitive, and subject to specific governmental regulation, special tax treatment, and public scrutiny. Accordingly, before starting an engagement to audit an investment company's financial statements, an auditor should become familiar with the entity's business, its organization, and its operating characteristics, as well as with the industry's terminology, legislation, and regulation.

Types of Investment Companies

1.03 Several types of investment companies exist: management investment companies, unit investment trusts, collective trust funds, investment partnerships, certain separate accounts of life insurance companies, and offshore funds. Management investment companies may be open-end funds, usually known as mutual funds, closed-end funds, special purpose funds, venture capital investment companies, small business investment companies (SBICs), and business development companies (BDCs). Investment companies are organized as corporations (in the case of mutual funds, under the laws of the minority of states that authorize the issuance of common shares redeemable on demand of individual shareholders), common law trusts (sometimes called *business* or *Massachusetts* trusts), limited partnerships, and other more specialized entities, such as separate accounts of insurance companies that are not in themselves entities at all except in the technical conception of the Investment Company Act of 1940 (the 1940 Act).

1.04 The accounting principles and auditing procedures discussed in this guide generally apply to all investment companies, though the guide has been written primarily for auditors of mutual funds and closed-end companies registered with the Securities and Exchange Commission (SEC) under the 1940 Act. Such companies are the most common forms of investment companies and are required to follow many regulations prescribed by the SEC.

1.05 Though many aspects of venture capital investment companies, including SBICs and BDCs, differ from aspects of other types of investment companies, the provisions of this guide generally apply. (Venture capital investment companies are discussed in appendix A.)

1.06 Investment companies discussed in this guide are required to report their investment assets at value and have the following attributes:[2]

a. *Investment activity.* The investment company's primary business activity involves investing its assets, usually in the securities of

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[1] In this guide, the term *investment company* refers to an entity with the attributes described in this chapter. It is not used to conform with the legal definition of an investment company in the federal securities laws.

[2] This guide does not apply to real estate investment trusts, which have some of the attributes of investment companies but are covered by other generally accepted accounting principles.

other entities not under common management, for current income, appreciation, or both.

b. *Unit ownership.* Ownership in the investment company is represented by units of investments, such as shares of stock or partnership interests, to which proportionate shares of net assets can be attributed.

c. *Pooling of funds.* The funds of the investment company's owners are pooled to avail owners of professional investment management.

d. *Reporting entity.* The investment company is the primary reporting entity.

History

1.07 The concept of investment companies originated in England in 1868 with the formation of the Foreign and Colonial Government Trust. Its purpose was to provide investors of moderate means with the same advantages as those of more affluent investors—that is, to diminish the risks by spreading investments over a number of different securities. Massachusetts Investors Trust, the first mutual fund, was organized in 1924. Small business investment companies started to be formed after the Small Business Investment Act of 1958 (the 1958 Act) was enacted.

1.08 The investment company industry has changed considerably since its origin and has attracted insurance companies, conglomerates, banks, and others as sponsors to perform advisory or distribution services. Initially, the industry was characterized by one- or two-person managements, relatively simple investment techniques, and rudimentary sales practices. Today, investment techniques are more sophisticated, and selling practices are more creative and aggressive. For example, the 1970s saw the advent of tax-exempt and money market funds, both of which necessitated new investment expertise and increasingly sophisticated data processing capability. In addition, funds referred to as series funds have become more common. Originally developed as an efficient method of registration, series funds are now also viewed as a new type of investment program for shareholders.

1.09 At the request of the SEC, the securities industry, including the investment company industry, has often been subject to intensive review. Notable reports emanating from those efforts include *A Study of Mutual Funds* (Wharton School Report, 1962), *Public Policy Implications of Investment Company Growth* (1966), *Wheat Report* (1960), and *Policy Statement on Future Structure of the Securities Markets* (1972).

Definition and Classification

1.10 The term *mutual fund* is the popular name for an open-end management investment company as defined in the 1940 Act. An open-end company is ready to redeem its outstanding shares, based on net asset value, at any time. Shares of an open-end company normally are not traded. Most open-end companies offer their shares for sale to the public continuously, though they are not required to do so. The price at which the shares of most mutual funds are sold is derived from each fund's net assets stated at value, divided by the number of shares outstanding; the resulting per share net asset value may be increased by a sales charge, called a *load,* that provides commissions to the underwriter and dealer. Funds whose shares are sold at net asset value with no sales charge are known as *no-load funds.* Some funds may charge fees when shares are redeemed, but generally shares are redeemed at net asset value.

1.11 A closed-end management investment company is not ready to redeem its outstanding capital shares at any time but may offer shares to the public at its discretion. However, shareholders of many, though not all, such companies may reinvest dividends in additional shares. Its outstanding shares are traded on the open market at prices that may differ from net asset value per share, though market prices are influenced by net asset value per share (investments are valued like those of mutual funds), which is regularly reported in financial publications.

1.12 Investment companies are classified as diversified or nondiversified and grouped according to their primary investment objectives, for example, income, growth, balanced, money market, or tax-exempt investment companies, or combinations of those groups.[3] The types of investments made by those funds reflect their stated objectives. For example, growth funds invest almost exclusively in securities with appreciation potential, whereas money market funds invest solely in money market instruments. Shareholder approval is required for an investment company registered as diversified to become nondiversified but not for a company registered as nondiversified to become diversified. If a nondiversified company operates as a diversified company, it may change back to a nondiversified company within three years of the change to a diversified company without shareholder approval, provided that its registration statement has not been amended.

1.13 Closed-end investment companies include venture capital investment companies, such as SBICs and BDCs. A venture capital investment company is a closed-end company whose primary investment objective is capital growth and whose capital is invested at above-average risk to form or develop companies with new ideas, products, or processes. An SBIC is an entity that provides equity capital, long-term loans, or both to small businesses; is licensed by the Small Business Administration under the 1958 Act; and may also be registered under the 1940 Act or be a subsidiary of a 1940 Act company. It may obtain financing from the federal government in the form of subordinated debentures based on the amount of its equity capital and the amount of its funds invested in venture-type investments.

1.14 A unit investment trust is an investment company organized under a trust indenture or similar instrument. It has no board of directors and issues only redeemable units, each representing an undivided interest in a group of securities (such as corporate debentures or municipal debt) or in a unit of specified securities or securities of a single issuer (such as shares of a particular mutual fund). Unit investment trusts that provide a formal method of accumulating mutual fund shares under a periodic payment plan or a single payment plan are commonly known as *contractual plans.* Chapter 6 discusses those plans.

Organizations Providing Services to Investment Companies

1.15 Most mutual funds and many closed-end investment companies have no employees. Portfolio management, sales of shares, administration, record keeping, and custodianship are the significant activities required by such funds and companies. They generally are performed by organizations other than the investment company: an investment adviser (manager), a principal underwriter (distributor), a custodian, a record-keeping agent, and a transfer agent. The distributor is usually a separate division or subsidiary company of the manager. The use of agents to perform accounting or other administrative

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[3] Section 5(b) of the Investment Company Act of 1940 (the 1940 Act).

functions does not relieve the investment company's officers and directors of the responsibility for overseeing the maintenance and reliability of accounting records and the fairness of financial reports.

The Manager

1.16 The manager generally provides investment advice, research services, and certain administrative services under a contract, commonly referred to as the investment advisory agreement, that provides for an annual fee, which is usually based on a specified percentage of average net assets. The fee schedules of most contracts provide for a reduced percentage rate on net assets in excess of specified amounts. Other contracts have performance fee schedules that provide for a basic fee percentage plus a bonus, or less a penalty, if the fund's performance exceeds or fails to exceed changes in a market index specified in the investment advisory agreement. If a performance fee schedule is used, the potential bonus for performance better than the index must be matched by an equivalent potential penalty for poor performance.[4] Sometimes, the advisory fee may be based wholly or partly on the investment income earned by the fund.

1.17 The investment advisory agreement must be approved by a majority of the directors who are not interested persons, as defined by the 1940 Act, and by a vote of a majority of the fund's outstanding shares. Continuation of the contract beyond two years requires annual approval, cast in person (usually conceding to mean face to face, not by telephone), (*a*) by a vote of the board of directors or of a majority of the outstanding shares and (*b*) by a vote of directors who are not interested persons.[5] A fund's total expenses may be limited to a certain percentage of average net assets under the contract's specific provisions, or they may be limited under the statutes of the various state securities regulations (Blue Sky laws).

The Distributor

1.18 The distributor acts as an agent or a principal and sells the fund's shares as a wholesaler through independent dealers or as a retailer through its own sales network. Shares are sold at net asset value, and often a sales charge (load) is added for the underwriters' and dealers' commissions. The amount of that sales charge is regulated by the National Association of Securities Dealers (NASD). Additionally, rule 22d-1 of the 1940 Act permits funds to set variable sales charges. A no-load fund may or may not have a distributor.

1.19 Requirements for approval of a distributor's contract by the fund's board of directors are similar to those described for the investment adviser, and if there is board approval, shareholder approval is not required. Sometimes funds adopt distribution plans under rule 12b-1; these plans allow the use of fund assets to pay for distribution expenses. One of the special requirements of that rule is that members of the board of directors who are not interested persons, as defined, must approve the plan each year.

The Custodian

1.20 Custody of the company's cash and portfolio securities is usually entrusted to a bank or, less frequently, to a member of a national securities exchange, which is responsible for their receipt, delivery, and safekeeping. Custody arrangements and the auditor's responsibilities are discussed in detail in chapter 2.

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[4] SEC Release No. 7484 under the 1940 Act.

[5] Sections 2(a)(19), 15(a), and 15(c) of the 1940 Act.

The Transfer Agent

1.21 The fund's transfer agent, which may be a bank or a private company, issues, transfers, redeems, and accounts for the fund's capital shares. Sometimes the manager, distributor, or other related party performs those functions. Section 17A of the Securities Exchange Act of 1934 requires certain transfer agents to register with the SEC and prescribes standards of performance concerning their duties.

Regulation

1.22 Generally, an investment company is required to register with the SEC under the 1940 Act [6] if one of the following is true:

a. Its outstanding securities, other than short-term paper, are beneficially owned by more than 100 persons (including the number of beneficial security holders of a company owning 10 percent or more of the voting securities of the investment company).

b. It is offering or proposing to offer its securities to the public.

The Division of Investment Management of the SEC is responsible for reviewing such registrations. The investment company's shares are also registered under the Securities Act of 1933 (the 1933 Act) and with various state securities commissions before being offered for sale to the public. After registering with the SEC under the 1940 Act or under both acts, the company must report periodically to its shareholders and to the SEC. Accordingly, auditors of investment companies should be familiar with the following acts:

a. The Securities Act of 1933, often referred to as the disclosure act, regulates the contents of prospectuses and similar documents and is intended to assure that potential investors receive adequate information to make reasonably informed investment decisions.

b. The Securities Exchange Act of 1934 (the 1934 Act) regulates securities brokers and dealers, stock exchanges, and the trading of securities in the securities markets. The principal underwriter of the fund's shares, often referred to as the distributor, must register as a broker-dealer under the 1934 Act. The 1934 Act also governs disclosures in proxy materials used to solicit the votes of shareholders of an investment company, as does the 1940 Act. If the fund's transfer agent is not a bank, it should be registered under the 1934 Act.

c. The Investment Company Act of 1940 regulates the investment company industry and provides rules and regulations that govern the fiduciary duties and other responsibilities of an investment company's management. Business development companies also register under this act.

d. The Investment Advisers Act of 1940 requires persons paid to render investment advice to individuals or institutions, including investment companies, to register, and regulates their conduct and contracts.

e. The Small Business Investment Act of 1958 authorizes the Small Business Administration to provide government funds under regulated conditions to small business investment companies licensed under this act.

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[6] Otherwise, the company is exempted from registration by section 3(c)(1) of the 1940 Act.

f. The Small Business Incentive Act of 1980 amended the 1940 Act by, among other things, allowing certain closed-end companies to elect to be regulated as business development companies under the somewhat less rigorous sections 54 through 65 of the 1940 Act.

1.23 The federal securities laws are supplemented by formal rules and regulations; the SEC also issues a variety of other releases and statements, including its financial reporting releases and releases under the 1933, 1934, and 1940 Acts and the Investment Advisers Act of 1940. Many apply to the investment company industry. The auditor should be familiar with them and with the SEC registration and reporting forms. The forms illustrate the kind of information that must be made available to the public, the restrictions imposed on operations, the most applicable statutory provisions, and the statistics that should be accumulated and maintained. The forms include the following:

- Form N-8A, the notification of registration under the 1940 Act, discloses the company's name and address and certain other general information. An investment company is registered under the 1940 Act after it has filed the form, which is brief, and is then subject to all of the Act's requirements and standards. The information in the form need not be audited.
- Form N-1A, the registration statement of management investment companies under the 1940 and the 1933 Acts, describes in detail the company's objectives, policies, management, investment restrictions, and similar matters. The initial filing of Form N-1A generally requires audited financial statements, which typically are limited to a "seed money" balance sheet. In September 1983, Form N-1A replaced Form N-1 for use by open-end management investment companies other than registered separate accounts of insurance companies (which use Form N-3 or N-4) and small business investment companies (which use Form N-5). (Form N-2 is the comparable registration statement for closed-end management investment companies.) The subsequent filing of posteffective amendments to the registration statement on Form N-1A is discussed in paragraph 1.24.
- Form N-SAR, a reporting form used for semiannual and annual reports by all registered investment companies that have filed a registration statement that has become effective pursuant to the Securities Act of 1933, is divided into four sections; only certain investment companies need to complete each section. The sections pertain to open-end and closed-end management investment companies, small business investment companies, or unit investment trusts. The report provides current information and demonstrates compliance with the 1940 Act. The annual report filed by a management investment company must be accompanied by a report on the company's system of internal accounting controls from its independent public accountant.
- Form 13F, a quarterly securities inventory of an institutional investment manager (including an investment company) that has either investment discretion or voting power over more than $100

million in listed or NASDAQ-quoted equity securities, is usually filed in composite form in the case of an investment adviser of multiple clients, including the combined holdings of investment companies and other clients.

- Schedule 13G and annual amendments, as of each December 31, to be filed by the following February 14, concern possession of either investment discretion or voting power over more than 5 percent of a class of equity securities of a publicly owned company, provided that the interests were acquired in the ordinary course and not with the purpose or effect of influencing control; if the proviso is inapplicable, disclosures of changes in holdings must be made promptly on Schedule 13D. Such reports are usually filed in composite form in the case of an investment adviser of multiple clients, including the combined holdings of investment companies and other clients.
- Form N-3 is the registration statement for variable annuity separate accounts registered as management investment companies under the 1940 Act and the Securities Act of 1933. It contains information and financial statements similar to the type required by Form N-1A, as well as information about the insurance contract and the sponsoring insurance company, including financial statements of the sponsor.
- Form N-4 is the registration statement for variable annuity separate accounts registered as unit investment trusts under the 1940 Act and the Securities Act of 1933. It contains information and financial statements similar to the type required by Form N-1A, as well as information about the insurance contract and the sponsoring insurance company, including financial statements of the sponsor.
- Form N-1 is the registration statement for variable life insurance separate accounts registered as management investment companies under the 1940 Act and the Securities Act of 1933.
- Forms N-8B-2 and S-6 are the forms for variable life insurance separate accounts registered as unit investment trusts, and at the present time for all other unit investment trusts except those registered on Form N-4 under the 1940 Act and the Securities Act of 1933.[7]
- Form N-5, the registration statement for SBICs, which are also licensed under the Small Business Investment Act of 1958, is a dual-purpose form registering an SBIC under both the 1933 Act and the 1940 Act. It contains the same type of information and audited financial statements as required by Forms N-1A and N-2 for management investment companies.
- Form N-14 is the statement for registration of securities issued by investment companies in business combination transactions under the 1933 Act. It contains information about the companies involved in the transaction and historical pro forma financial statements.

[7] Under the SEC's May 14, 1985 proposal, release 33-6580, Forms S-6 and N-8B-2 for registration of unit investment trusts (other than variable life insurance separate accounts) under the 1933 Act and the 1940 Act would be replaced by Form N-7. Form S-6 would continue to apply to flexible premium variable life insurance or universal life insurance separate accounts.

Forms N-8B-2 and S-6 apply only to unit investment trusts. Other forms apply to special situations.

1.24 Information in a currently effective prospectus must be updated for significant events that have occurred since the effective date. Prospectuses of mutual funds offering their shares for sale generally are updated at least annually. Posteffective amendments on Form N-1A, including updated audited financial statements, must be filed and become effective under the 1933 and 1940 Acts within sixteen months after the end of the period covered by the previous audited financial statements if the fund is to continue offering its shares. In addition, based on undertakings agreed to with the SEC, newly registered investment companies update financial statements included in the initial registration statement by filing a posteffective amendment within four to six months after the date of the registration statement.

1.25 Registration statements and reports filed by open-end and closed-end companies (other than SBICs) on various forms include condensed financial information (usually for the preceding ten years), as described in the instructions to Form N-1A.

1.26 The form and content of financial statements required in registration statements are governed by Regulation S-X, article 6, which deals specifically with investment companies. (SBICs are covered in article 5.)

Stockholder Reporting

1.27 The 1940 Act and the related rules and regulations specify the financial statements and the timing of reports required to be submitted to stockholders and to the SEC.[8] Reports containing those financial statements must be submitted to stockholders and to the SEC at least semiannually; annual reports must contain audited financial statements. The reports contain—

- A statement of assets and liabilities and a detailed schedule of investments or a statement of net assets.
- A statement of operations.
- A statement of changes in net assets.
- A schedule of selected per share data.

Financial statements for management investment companies are discussed and illustrated in chapter 5.

Accounting Rules and Policies

1.28 Rules under the 1940 Act prescribe the accounting records that an investment company must maintain and the periods for which they must be retained.[9] Those rules require maintenance of journals, general and subsidiary ledgers, and memorandum records, which are subject to examination by representatives of the SEC during periodic and special examinations.

1.29 The accounting policies followed by an investment company result from the company's role as a conduit for the funds of investors interested in investing as a group. The policies are influenced by the rules and regulations issued under the various acts administered by the SEC and the Small Business Administration, and by the Internal Revenue Code's specific provisions relating to investment companies. Some of the unique policies are described below and in more detail in the following chapters.

[8] Rules under section 30(d) of the 1940 Act.
[9] Rules under section 31 of the 1940 Act.

Valuation of Securities

1.30 Values and changes in values of securities held by investment companies are as important to investors as the investment income earned. Investment companies, therefore, report securities at quoted market prices or, in the absence of quoted prices, at amounts representing estimates of fair values using methods determined in good faith by the directors.

Effective Date of Transactions

1.31 The established practice in accounting for security purchases and sales is to record transactions as of the trade date, the date on which the company agrees to purchase or sell the securities, so that the effects of all securities trades entered into by or for the account of the investment company to the date of a financial report are included in the financial report.[10] Investment companies record dividend income on the ex-dividend date, not on the later record or payable date, because on the ex-dividend date the quoted market price of listed and other market-traded securities tends to be affected by the exclusion of the dividend declared. Also, investment companies record liabilities for dividends to shareholders on the ex-dividend or ex-distribution date, not on the declaration date as other corporations do, because mutual fund shares are purchased and redeemed at prices equal to or based on net asset value. Investors purchasing shares between the declaration and ex-dividend dates are entitled to receive the dividend, whereas investors purchasing shares on or after the ex-dividend date are not entitled to the dividend.

Equalization

1.32 Certain open-end investment companies use the accounting practice of equalization, which is unique to their industry. The practice was adopted in the 1930s to try to keep the continuing shareholders' interest in undistributed income from being affected by changes in the number of shares outstanding by applying a portion of the proceeds from sales and costs of repurchases of capital shares to undistributed income.

1.33 The equalization theory states that the net asset value of each share of capital stock sold or repurchased comprises the par value of the stock, undistributed income, and paid-in and other surplus. When shares are sold or repurchased, the investment company calculates the amount of undistributed income available for distribution to its shareholders and, based on the number of shares outstanding, determines the amount associated with each share. The per share amount so determined is credited to the equalization account when shares are sold and is charged to the equalization account when shares are repurchased.

1.34 The following is an example of equalization. An investment company has 1 million shares outstanding and net assets of $7,500,000, including $500,000 of undistributed income. The investment company receives $7.50 for each share sold and accounts for those proceeds by crediting $7.00 to capital stock and paid-in surplus, and $0.50 to the equalization account ($500,000 of undistributed income divided by 1 million shares). For shares repurchased on that date, the same amounts are charged to the equalization, capital stock, and paid-in surplus accounts. Accordingly, regardless of the volume of shares sold or repurchased, equalization permits each share of capital stock to retain the same per share amount of undistributed income that it earned or acquired.

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[10] Rule 2a-4 of the 1940 Act.

1.35 Conversely, if equalization is not applied, each shareholder's per share equity in undistributed income fluctuates as the number of shares outstanding increases or decreases. Using the same illustration, the per share equity in undistributed income would fall from $0.50 to $0.40 if 250,000 additional shares of capital stock were sold or would increase to $0.55 if 100,000 shares were repurchased. Conceptually, the excess of equalization credits over debits should be distributed to shareholders; as a practical matter, it is frequently not done. Equalization accounting does not significantly affect the amount of undistributed income unless the investment company experiences significant changes in outstanding shares and does not consider equalization when determining its distributions to shareholders.

1.36 Equalization of accumulated net investment losses, accumulated unrealized gains or losses, or undistributed realized gains or losses from securities transactions is not a generally accepted practice. Equalization of accumulated net investment losses does not affect the amount of income to be distributed for tax purposes, and may create a meaningless balance in the undistributed income account. Similarly, equalization of realized or unrealized gains would create meaningless balances because such gains might not, in fact, be distributed. (Chapter 4 discusses the tax aspects of equalization.)

Taxes

1.37 No provision for federal income taxes is required for investment companies that qualify under subchapter M of the Internal Revenue Code and that distribute all their investment company taxable income and taxable realized gains from securities transactions. If such companies do not distribute realized long-term gains on securities transactions but elect to pay the federal income tax on such gains for their shareholders, the liability and the related deemed distribution are recorded at the end of the last day of the investment company's taxable year (not earlier), because only shareholders of record at that date are entitled to the credit for taxes paid on their behalf by the investment company.[11]

1.38 State, local, and foreign taxes, if payable, are reported on the accrual basis, including deferred state, local, and foreign taxes on the unrealized appreciation or depreciation of investments if material to net assets.[12]

1.39 If a company does not qualify under subchapter M of the Internal Revenue Code, a provision for deferred federal income taxes on unrealized appreciation (or depreciation) of investments is ordinarily required in addition to federal income taxes on net investment income and realized gains or losses on investments. Taxes are discussed in more detail in chapter 4.

Other Rules

1.40 The 1934 Act specifies the records that must be maintained by the principal underwriter for the fund, the period for which the records must be preserved, and the reports that must be filed by the principal underwriter with the SEC.[13] The records may be examined by representatives of the SEC. Once during each calendar year, each principal underwriter is required (as are

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[11] SEC, *Codification of Financial Reporting Policies,* section 404-06.b.

[12] Accounting Principles Board (APB) Opinion No. 11, *Accounting for Income Taxes,* paragraphs 34 through 37. [Note: Financial Accounting Standards Board (FASB) Statement No. 109, *Accounting for Income Taxes,* is effective for fiscal years beginning after December 15, 1992. It will supersede APB Opinion No. 11 and FASB Statement No. 96, *Accounting for Income Taxes.*]

[13] Rules 17a-4 and 17a-5 of the Securities Exchange Act of 1934.

other brokers and dealers) to file audited financial statements. The AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* provides additional discussion.

1.41 The 1940 Act specifies the type of notice to stockholders that should accompany distributions from sources other than accumulated undistributed income, describing the source of such distributions.[14] That notice must clearly indicate the portion of the payment (per share of outstanding capital stock) made from net income or accumulated undistributed net income, realized gains or accumulated undistributed net gains on the sale of securities, and paid-in surplus or other capital sources.

1.42 The 1940 Act requires that the independent auditor reporting on financial statements of a management investment company be selected annually by a majority of directors who are not interested persons at a meeting held within thirty days before or after the beginning of the fiscal year or before the annual meeting of stockholders. The directors' selection must be submitted to the stockholders for ratification at their next succeeding annual meeting. If the independent auditor resigns or is unable to carry out the engagement, the disinterested directors may appoint a successor.[15]

[14] Section 19 and rule 19a-1 of the 1940 Act.
[15] Section 32(a)(2) of the 1940 Act.

Chapter 2

Investment Accounts

2.01 An investment company's securities portfolio typically consists of virtually all its assets. Portfolio securities produce income from dividends, interest, and changes in market values of securities while they are owned by the fund.

Investment Objectives and Policies

2.02 The composition of an investment company's portfolio is primarily a function of the company's investment objectives and its market strategy to achieve them. An investment company discloses the investment objectives adopted by its management and the strategies adopted to achieve them in its charter or partnership agreement and in documents such as registration statements, prospectuses, or offering circulars. Restrictions, statutory or otherwise, are also disclosed. Those may include specific limitations or outright prohibitions of transactions in real estate, commodities or commodity contracts, and property other than securities. Other restrictions may include investing in unregistered securities, making short sales of securities, underwriting securities of other issuers, acquiring securities of other investment companies, or using leveraging techniques, such as margin accounts, bank borrowing, and transactions in options.

2.03 An investment company may also specify the types of securities—such as bonds, preferred stocks, convertible securities, common stocks, warrants, or options—in which it may invest and the proportion of its total assets that may be invested in each type of security. Specific limitations generally relate to—

a. The percentage of a company's assets it may invest in the securities of an issuer.

b. The percentage of voting securities of an issuer it may acquire.

c. Investments in companies for the purpose of control.

If a company changes any of its fundamental investment policies set forth in accordance with section 8(b) of the 1940 Act, it is required by section 13(a) of the act to obtain shareholders' approval.

Federal Income Tax Provisions Affecting Investment Accounts

2.04 In establishing investment policies, companies that qualify as regulated investment companies under subchapter M of the Internal Revenue Code should consider the requirements of subchapter M relating to diversification of assets, sources of income and realized gains, and similar matters. Those requirements are described in chapter 4.

Operations and Controls

Record-keeping Requirements

2.05 The 1940 Act prescribes minimum accounting records for registered investment companies.[16] The basic required investment records, for all investment companies, are—

[16] Section 31 of the 1940 Act and rules under that section.

a. Journals or other records of original entry that contain itemized daily records of all securities purchases and sales, receipts and deliveries of securities, and collections and payments of cash for securities transactions.

b. A securities record or ledger showing the unit, quantity, price, and aggregate price separately for each portfolio item and for each transaction, as of the trade date.

c. A record for each portfolio item of all trading orders for purchase or sale by or on behalf of the investment company and the action on each order.

The required books and records are subject to retention and inspection requirements set forth in rules under the 1940 Act.[17]

2.06 If any records required to be maintained by the regulations are maintained by an agent, such as a custodian or transfer agent, the company should obtain the agent's written agreement to make the records available on request and to preserve them for the required periods.

Custody of Securities

2.07 An investment company's securities are usually held in the custody of a bank, which must have prescribed minimum aggregate capital, surplus, and undivided profits.[18] A member firm of a national securities exchange or a central securities system registered with the SEC also may serve as custodian. To use a member of a national securities exchange as custodian, a registered company must obtain the approval of a majority of its board of directors initially and at least annually afterwards. The 1940 Act and the related rules require that securities held in custody by a member of a national securities exchange be inspected at various times by the investment company's independent auditor and that the auditor issue a report thereon to the SEC.[19] (See also the discussion in paragraph 2.91 relating to foreign custodian arrangements and in paragraphs 2.119 and 2.120 relating to the auditor's involvement in the review of custody procedures.)

2.08 Having a custodial agreement that is approved annually by the board of directors, although not required in all instances, is good practice for all companies.[20] Registered companies are required to file copies of their custodial agreements with the SEC. Significant provisions of such agreements deal with—

a. Physical and book segregation of securities in custody.

b. Denying custodians the power to assign, hypothecate, pledge, or otherwise encumber or dispose of any securities except in acting at the direction and for the account of the investment companies.

c. Immunity of such securities to liens asserted by the custodians.

d. The right of the SEC and the companies' independent auditors to inspect the securities at any time.[21]

2.09 An investment company may retain custody of its securities by depositing them for safekeeping in a vault or other depository maintained by a bank or a company whose functions and physical facilities are supervised by federal or state authorities. The 1940 Act and the related rules require all

[17] Rules 31a-2, 31a-3, and 31b of the 1940 Act.
[18] Sections 17(f) and 26(a) of the 1940 Act.
[19] Rule 17f-1 of the 1940 Act.
[20] Section 17(f) of the 1940 Act and guidelines.
[21] Section 17(f) of the 1940 Act.

securities in safekeeping to be inspected at various times by the investment company's independent auditor.[22] The deposited securities are required to be physically segregated and subject to withdrawal only by duly authorized persons under specified conditions.

2.10 An investment company using a bank or a member of a national securities exchange as custodian of its securities may agree to have qualifying securities deposited in a clearing agency—a central securities system—that is registered with the SEC. Clearing agencies use book entry methods of accounting for securities transfers rather than methods based on the physical movement of the securities. Most investment companies' portfolio securities that qualify are now held by clearing agencies (such as Depositary Trust Company) through arrangements with the investment companies' custodians, instead of being held by the custodians in physically issued form. Investment companies or their custodians may also use the federal reserve or treasury book entry system as a depository for U.S. and federal agency securities. Special rules apply to the use of central securities systems and book entry systems.[23]

2.11 If a registered investment company uses a bank as custodian for its securities, the proceeds from sales of such securities and other cash assets, except for minor amounts in checking or petty cash accounts approved by the board of directors, are required to be kept in the bank's custody.[24]

Routine Investment Procedures

2.12 Although the overall direction of the investment activities of an investment company is the responsibility of its board of directors, the board typically delegates the routine operating and investment decisions to an investment committee, a portfolio manager, or an investment adviser. Investment decisions are communicated to the investment company's adviser or employees who place orders with brokers. An investment company's prospectus indicates its policies on selecting brokers and on using affiliates to execute trades. A well-designed system of controls for investment transactions would include the procedures described in the following paragraphs.

2.13 An investment company is required by section 31(a-1) of the 1940 Act to document the placement of a securities order in an internal record that shows the person who authorized and placed it, the security, the number of shares or the principal amount ordered, the price, the date and time at which the order was entered and executed, the commission rate or amount, the broker selected, and the reason for the selection. Executed transactions are routinely confirmed by telephone, and confirmations are followed by written advices containing all information pertinent to the trades. The written advices for money market instruments ordered through a bank often consist of bank debit or credit memorandums.

2.14 An investment company should promptly notify the custodian of each securities transaction and issue detailed written instructions to receive or deliver securities and to collect or disburse cash. Those instructions should include the name of the broker, the description and quantity of the security, the trade and settlement dates, and the net amount of cash to be collected or disbursed. An amendment to New York Stock Exchange rule 387, effective in 1983, requires the electronic depository confirmation-affirmation system (also known as Broker ID System) to be used to effect securities transactions on a COD or POD status. The Internal Revenue Code requires use of either the

[22] Rule 17f-2 of the 1940 Act.
[23] Rule 17f-4 of the 1940 Act.
[24] Release Nos. 6863 and 7164 under the 1940 Act.

specific identification or the FIFO method in computing costs of securities sold. Therefore, for sales transactions the instructions should identify the certificate numbers of the securities to be delivered, the date of purchase, or other acceptable methods of identification under the Internal Revenue Code. The instructions should be signed by one or more authorized representatives of the investment company whose signatures are on file with the custodian; if instructions are given by telephone or telegraph, written confirmation of the instructions should follow promptly.

2.15 As advices confirming trades are received, they should be reviewed promptly for conformity of terms, clerical accuracy, and proper application of commission rates—including volume discounts or negotiated rates, as applicable—and should be compared to the internal records established when the orders were placed.

2.16 Investment companies almost always require payment in cash for securities delivered by the custodian to settle sales of portfolio investments. Similarly, the custodian pays cash when securities purchased by the investment company are delivered. Unless otherwise instructed, the custodian normally rejects a transaction if either the number of shares or the settlement amount determined by the broker does not agree with the written instructions previously authorized by the investment company.

2.17 The custodian promptly notifies the investment company of cash settlements and receipts or deliveries of securities. The related advices should again be compared to the investment company's records. On receipt of such advices, the investment company should compare them against its records to identify discrepancies. Fails to receive or deliver should be identified on the settlement date and followed up promptly.

2.18 The custodian issues periodic statements listing all receipts and deliveries of securities and related collections and disbursements of cash. Securities on hand and the cash balance at the end of the period may be shown following the chronological list of transactions. An investment company should promptly reconcile the custodian's statements with its books and records and should initiate timely follow-up procedures on reconciling items. The investment company should be satisfied with the adequacy of the custodian's procedures and controls that relate to functions carried out on its behalf, especially procedures and controls for receipt, delivery, and safekeeping of securities.

Accounting

Net Asset Value Per Share

2.19 All open-end investment companies and some closed-end investment companies typically prepare daily price makeup sheets computing net asset value per share each day the New York Stock Exchange conducts trading activity. Other closed-end companies may do so less frequently, such as weekly or semimonthly. Under the 1940 Act, open-end investment companies offering their shares to the public continuously are required to compute net asset value per share daily to price shares redeemed and sold.[25] Rule 22c-1(b) establishes customary U.S. business days as the days on which an investment company, at a minimum, must price its redeemable securities, provided customer orders have been received and there is significant trading in the fund's portfolio securities.

[25] Rule 22c-1 of the 1940 Act.

2.20 The most significant portion of an investment company's assets is its securities portfolio, which is stated at value or at an estimate of value (sometimes referred to as fair value). For shareholders' equity to be reported properly, securities are valued and income and expenses accrued at least as often as net asset value is computed or shares are issued or redeemed. Changes in security positions should be reflected in the daily net asset value computations no later than the first calculation following the trade date.[26] Those calculations reflect that—

- Portfolio securities are valued as discussed in a later section of this chapter.
- Changes in investments are included no later than the first business day after the trade date.
- Changes in the number of the investment company's outstanding shares from sales, distributions, and repurchases are included no later than the first business day after such changes.
- Expenses are accrued to the date of the calculation.
- Dividends receivable are recognized at ex-dividend dates.
- Interest and other income are accrued to the date of calculation.[27]

2.21 Federal income taxes payable on security gains that the investment company elects to retain are accrued only on the last day of the tax year.[28] The company normally estimates its other expenses for the year, as well as for the period within which they will be incurred, and allocates them, generally daily, in computing net asset value. Estimated annual expenses should be reviewed continually and accruals adjusted as required.

2.22 Other aspects of accrual accounting peculiar to investment companies, discussed in this and other chapters of the guide, should also be considered. The 1940 Act does not require expenses, income items, or both to be accrued daily if their net cumulative amount is less than one cent per outstanding share.[29] Dividends payable, discussed in chapters 1 and 3, are recorded on the ex-dividend date.

2.23 Because of the importance of the calculation of net asset value per share, many investment companies require responsible employees to independently check all securities prices and to review the portfolio value computation. As an added precaution, values assigned to each security position may be compared with the values used on the preceding valuation date to detect increases or decreases in specific security values that are unusual or that exceed predetermined amounts or percentages. It is advisable to review and explain such increases or decreases.

Basis of Recording Securities Transactions

2.24 As previously indicated, the generally accepted practice in the investment company industry is to record securities transactions as of the trade date rather than the settlement date. For that reason, the statement of assets and liabilities of most investment companies at the end of an accounting period includes receivables from brokers for securities sold but not delivered and payables to brokers for securities purchased but not received.

2.25 A securities transaction outside conventional stock market channels, such as through a private placement of investment letter stock or by submit-

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[26] Rule 2a-4 of the 1940 Act.
[27] Ibid.
[28] SEC, *Codification of Financial Reporting Policies,* section 404.06.b.
[29] Rule 2a-4(b) of the 1940 Act.

ting shares in a tender offer, should be recorded as of the date the investment company obtained an enforceable right to demand the securities purchased or to collect the proceeds of sale, and incurred an enforceable obligation to pay the price of the securities purchased or to deliver the securities sold, respectively. Determining the recording date may sometimes require an interpretation by legal counsel.[30]

Basic Methods of Valuing Securities

2.26 Investment companies report their investment securities at value, defined as the quoted market price for securities for which market quotations are readily available, or as an estimate of value (fair value) as determined in good faith by the board of directors for other securities.[31] Registered companies value their portfolio at such time of day and frequency as determined by their boards of directors, a determination that should be made at least annually.[32] The value reported for securities held is not reduced by estimated brokerage commissions and other selling costs that would be incurred in a sale.

2.27 An investment company's prospectus describes the methods used to value its securities.[33] Section 404.03 of the SEC's *Codification of Financial Reporting Policies* describes various methods for valuing securities. Those methods are discussed in this section. The application of those methods in valuing various types of securities is discussed in the sections on accounting for those types of securities.

Listed Securities

2.28 Valuing securities listed or traded on one or more securities exchanges ordinarily is not difficult, because quotations of completed transactions are published daily. A security traded on the valuation date generally is valued at the last quoted sales price. A security listed on more than one national securities exchange should be valued at the last quoted sales price at the time of valuation on the exchange on which the security is principally traded. If the security was not sold on that exchange on the valuation date, the security should be valued at the last quoted sales price on another exchange on which it was sold at the valuation date. The value of corporate bonds traded on a national exchange and over the counter should be determined by the market in which representative amounts of securities are normally traded.

2.29 Securities not traded on the valuation date for which published closing bid and asked prices are available should be valued within the range of the closing bid and asked prices. As a general policy, some companies use the bid price, some the mean of the bid and asked prices, and some a valuation within the range considered to best represent value in the circumstances. Each of those policies is acceptable if applied consistently. Normally, the asked price alone is not acceptable. If only a bid price or an asked price is available for a security on the valuation date, or if the spread between the bid and asked price is substantial on that date, quotations for several days should be reviewed.

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[30] SEC, *Codification of Financial Reporting Policies*, section 404.03.a.

[31] Section 2(a)(41) of the 1940 Act.

[32] Rule 22c-1(b) of the 1940 Act.

[33] Guide 28, "Valuation of Securities Being Offered," *Guidelines for Form N-1A*, Investment Company Act Release No. IC-13436.

Over-the-Counter Securities

2.30 For most unlisted securities traded regularly in the over-the-counter market, quotations are available from various sources. Those sources include the financial press, various quotation publications and financial reporting services, individual broker-dealers, and the NASD National Market System (NMS), which provides information on the last sale price on NASDAQ. For unlisted securities not traded on the valuation date, a company may adopt a policy of using the mean of the bid prices, the mean of the bid and asked prices, the mean of the price quotations of a representative selection of broker-dealers, or a valuation within the range of bid and asked prices considered to best represent value in the circumstances. Each of those policies is acceptable if consistently applied.

2.31 Quotations for an over-the-counter security should ordinarily be obtained from more than one broker-dealer, unless they are available from an established market maker for that security. The quotations should always be obtained from unaffiliated entities, and quotations for several days should be reviewed. NASDAQ may be the most convenient source of such quotations. If a security has been sold infrequently or if the market in the security is thin, the reliability of market quotations should be considered. If market quotations for the security are deemed not reliable, an estimate of value, as determined in good faith by the board of directors, should be used.

Securities Valued in Good Faith

2.32 In certain circumstances, it may be necessary to estimate the fair value of securities if market quotations are not available. The objective of the estimating procedures is to state the securities at the amount the owner could reasonably expect to receive for them in a current sale, though the owner may not intend to sell them. The SEC's *Codification of Financial Reporting Policies* provides guidance on the factors to be considered, and on the responsibilities for and methods used to value securities for which market quotations are not readily available.[34] The term *current sale* means realization in an orderly disposition over a reasonable period. Valuation methods acceptable under that concept may be based, for example, on a multiple of earnings or on a discount from market, or, less frequently, on a premium higher than the market price of a similar freely traded security, on a yield to maturity on debt securities, or on a combination of those and other methods. Investments in several securities of the same issuer, such as investments of SBICs and venture capital investment companies, may be valued as a package. All relevant factors should be considered in selecting the method of estimating the fair value of each type of security or package of securities.

2.33 The board of directors should be satisfied that all relevant factors have been considered and that the method used to estimate value is acceptable. The information considered and the basis for the board's decision should be documented in the minutes of the directors' meeting, and the supporting data should be retained.[35] The board may appoint individuals to assist it in the estimating process and to make the necessary calculations.

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[34] SEC, *Codification of Financial Reporting Policies*, sections 404.03 and 404.04.

[35] Ibid.

Accounting for Specific Types of Securities

Money Market Investments

2.34 Short-term investments, such as short-term government obligations, commercial paper, bankers acceptances, and certificates of deposit, may be bought at face amount or at a discount from face amount. Those investments are accounted for at value determined on the basis of trade or bid and asked prices or at fair value based on evaluations by market makers or other acceptable evidence.

2.35 The amortized cost of money market instruments that mature within a relatively short period usually approximates market value. However, the impairment of the credit standing of the issuer or unusual changes in interest rates can significantly affect the market value of short-term investments. In those circumstances, amortized cost may not approximate the market value of such investments.

2.36 Section 404.05 of the SEC's *Codification of Financial Reporting Policies* indicates that the SEC does not object if an investment company's board of directors determines in good faith that amortized cost approximates the fair value of debt securities purchased with remaining maturities of sixty days or less, unless particular circumstances dictate that the securities should be valued at market or fair value as described above.

2.37 The SEC's rule 2a-7 and exemptive orders received by certain mutual funds from the SEC, particularly money market funds, allow the use, under certain restrictive conditions, of the amortized cost method to value an investment portfolio.

Municipal Bonds and Notes

2.38 The two principal classifications of municipal bonds are general obligation bonds and revenue bonds. General obligation bonds represent the issuer's unqualified pledge, based on its faith, credit, and taxing power, to pay principal and interest when due. Revenue bonds are payable from revenues derived from a particular class of facilities or from other specific revenue sources. Tax-exempt industrial development bonds are usually revenue bonds and generally do not carry the pledge of the issuer's credit. Yields on municipal bonds depend on a variety of factors, including market conditions, maturity date, ratings assigned to the issue, and tax-exempt status.

2.39 Municipal notes generally mature in less than three years. They are usually designated as tax, revenue, or bond anticipation notes because they are redeemable on receipt of anticipated taxes or revenues or on financing from the proceeds of municipal bonds. They include short-term tax-exempt project notes issued by public housing or urban renewal agencies of local communities with payment of principal and interest guaranteed by the United States government. Among investment companies, municipal bonds and notes are held primarily in the portfolios of tax-exempt municipal bond funds and require special considerations for valuation. They are traded in a dealer market in which little published price information is available. As a result, new issues of municipal bonds or notes are usually sold by competitive bidding. Subsequent market quotations may be obtained from dealers in those securities.

2.40 However, because trading activity is limited and the market in which the securities are traded is thin, dealer quotations may not indicate the prices at which municipal bonds may be bought or sold. Fair value is estimated by the sponsor or trustee of a unit investment trust or by a party having that responsibility under the trust agreement, and by the board of directors of a management investment company.

2.41 The value of such securities may be estimated using many methods. For example, quotations may be obtained from a market maker for individual securities; quotations from a number of market makers may be averaged; reliable quotations of similar securities may be considered; or matrix pricing may be used to value normal institutional-size trading units of debt securities without relying exclusively on quoted prices. Matrix pricing estimates an issue's current market value by considering such factors as coupon interest rate, maturity, credit rating, market indices, and other market data as they relate to the issue being valued and to similar issues for which quoted prices are available.

2.42 A number of municipal bond funds, primarily those organized as unit investment trusts with fixed portfolios, arrange for insurance for the payment of principal and interest when due. The insurance normally applies to portfolio securities only while they are owned by the fund, and its coverage is not transferable to buyers of the securities. That arrangement differs from those in which the issuer of the securities acquires the insurance, making the insurance feature an element of the securities and transferable on changes in ownership. If the insurance applies only to the fund's portfolio, it does not have a measurable value in the absence of default of the underlying securities or of indications of the probability of default.

2.43 A significant decline in the market price of a municipal security that appears to relate to the issuer's creditworthiness may indicate the probability of default. Comparisons of the market price of the security with market prices of similar securities or a downgrading of the issuer's credit ratings may indicate such a deterioration.

2.44 In an insured portfolio, the value of municipal bonds that are in default or for which the probability of default is indicated should be estimated by the board of directors in good faith. Some factors that should be considered in estimating value are the terms of the insurance policy, the intention and ability of the fund to hold the bonds until maturity, and the ability of the insurer to perform under the policy in the event of default.

When-Issued Securities

2.45 Some securities, principally municipal securities, are traded on a when-issued basis. A municipal securities underwriter solicits expressions of interest in a proposed issue and sends a when-issued price confirmation against which securities are delivered later when the terms of the issue are known. The securities normally begin trading on a when-issued basis on the issuance of the confirmation as if they had been issued a few days before the closing date.

2.46 Securities offerings are rarely aborted after when-issued trading begins. A when-issued security and the obligation to pay for the security should be recorded when the commitment becomes fixed, which is generally the date on which the priced transaction confirmation is issued, and the security should be reported at its value after that date. When-issued securities for which the fund has not taken delivery are required to be identified in the financial statements.[36] The same accounting methods should be used for securities bought on a delayed delivery contract under which the managing underwriter agrees to deliver securities to buyers at later specified dates.

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[36] SEC Release No. 10666 under the 1940 Act.

Mortgage-Backed Securities

2.47 Mortgage-backed securities generally represent investments in pools of mortgages on which payments of principal and interest may be guaranteed by the U.S. government or its agencies, such as Government National Mortgage Association (GNMA) issues. Those securities typically are *pass-through* instruments; that is, monthly payments on the mortgages in the pool, together with interest, are passed through to the investor in the security. A modified pass-through security pays the investor a scheduled monthly principal and interest payment, regardless of the amount actually collected from the mortgages in the pool.

2.48 Because investors in GNMA certificates do not know the exact amounts of monthly principal paydowns, amounts are estimated and recorded based on past experience. Subsequent interest accruals are also calculated based on estimated remaining principal balances. When the amounts of paydowns are determined, the estimates are adjusted.

Commodity and Financial Futures Contracts

2.49 Commodity and financial futures contracts [37] are traded on various exchanges and are thus distinguished from forward contracts, which are entered into privately by the parties.[38] A futures or forward contract is a firm commitment to buy or sell a specified quantity of a specified grade of a specified commodity, or, in the case of financial futures contracts, a standardized amount of a deliverable grade security at a specified price and specified future date unless the contract is settled before the delivery date.[39] For futures contracts, the date is a specified delivery month and the contract generally is settled by executing an offsetting futures contract before or during the delivery month. The quantity and quality provisions of futures contracts are standardized. For example, every cotton futures contract traded on the New York Cotton Exchange is for 50,000 lbs., and every Treasury bill futures contract traded on the International Money Market of the Chicago Mercantile Exchange is for $1 million.

2.50 Accounting for a futures contract transaction differs from that for a security transaction. Though a confirmation of the trade is submitted showing the pertinent price, quantity, and commodity data, usually no amount is entered in the ledger. The ledger reflects only the margin deposit and the daily mark to market for variation margin. Details of open contracts are in memorandum format.

2.51 To initiate a futures contract, the investor is required to make an initial margin deposit in an amount that is established by the various exchanges and that varies according to the commodity or security, the prevailing price, whether the investor is a speculator or hedger, and market conditions. The initial margin often may be made in Treasury bills, thus reducing the carrying cost of the contract. In those cases, the restriction on the

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[37] FASB Statement No. 80, *Accounting for Futures Contracts*, provides a more complete discussion of the subject.

[38] Rule 4.5 under the Commodity Exchange Act generally excludes registered investment companies from the definition of commodity pool operator, and the Commodity Futures Trading Commission (CFTC) release announcing the adoption of the rule indicates that the exclusion also applies to depositors, sponsors, underwriters, and investment advisers. If the exclusion is not applicable, an investment company that trades commodities is subject to regulation by the CFTC as a commodity pool operator, and may also be subject to regulation by the SEC under the 1933 Act. The auditor should become familiar with those regulations as they relate to accounting for such funds.

[39] Futures or forward contracts differ from options, which give buyers the right, but not the obligation, to close the transactions.

marketability of Treasury bills should be disclosed in the fund's schedule of investments. Member firms sometimes require margins in excess of those set by the exchanges.

2.52 An investment company normally uses a three-party special segregated custody account with its custodian bank and each of its futures brokers, and deposits initial margin on futures contracts with that broker in that segregated custody account. Cash or securities deposited to meet margin requirements should be identified as margin deposits on the investment company's records. Alternatively, the investment company may arrange to put up performance bonds.

2.53 Futures contracts are marked to market daily; that is, they are valued at the close of business each day, and a gain or loss is recorded for the difference between the value of the contracts that day and on the previous day. A corresponding entry for daily *variation margin* is recorded in a receivable or payable account. Variation margin is normally settled in cash with the broker each morning for the amount of the previous afternoon's mark to market. When a contract is closed, exchange fees and brokers' commissions are calculated. A final variation margin payment, net of such fees, is recorded, and a corresponding amount is recorded as a gain or loss.

2.54 Futures contracts ordinarily should be valued at the settlement prices established by the exchanges to determine appreciation or depreciation. However, exchanges limit fluctuations in prices of futures contracts during a single day for contracts other than the current month's delivery contracts by regulations referred to as *daily limits.* During a single trading day, trades may not be executed at prices exceeding the daily limit. Once the price of a futures contract has increased or decreased by an amount equal to the daily limit—that is, made a limit move—positions cannot be taken or liquidated unless traders are willing to trade at or within the limit. The bid price for a particular futures contract occasionally may move by the amount of the daily limit for several consecutive days with little or no trading. Contingent orders, such as stop loss orders, do not necessarily limit an investor's losses because market conditions may make it impossible to execute such orders.

2.55 The fair value of futures positions affected by a daily limit should be estimated by applying procedures established by the board of directors. The price of a commodity futures contract is sometimes greater than the spot price by an amount equal to the carrying cost of the physical commodity, which is an interest factor known as the *contango,* and a transportation charge.[40] Therefore, the fair value of a futures contract subject to daily limits can often be estimated by interpolation with reference to interest rates and either the value of the current delivery month contract or the spot price.

2.56 Open contracts are usually presented in the financial statements separately disclosing the type of contract, expiration date, and gain or loss on the contract.

Forward Placement Commitment Contracts

2.57 Forward placement commitment contracts are over-the-counter contracts for delayed delivery of securities in which the buyer agrees to buy (long) and the seller agrees to deliver (short) a specified security at a specified price on a specified future date.[41] The contracts generally deal with fixed interest

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[40] The price quoted for immediate delivery in a cash transaction.

[41] The SEC indicated in Release No. 10666 under the 1940 Act that an investment company's participation in a firm commitment agreement (forward placement commitment or agreement to purchase when-issued securities), standby commitment, or reverse repurchase

rate or yield commitments to buy or sell securities, such as GNMA pass-through mortgage-backed securities, Federal Home Loan Mortgage Association mortgage-backed securities, or transactions in delayed delivery or when-issued securities. Forward contracts are not traded on organized exchanges. Their terms are not standardized, and a contract generally can be terminated only by agreement of both parties to the contract.

2.58 If delivery or acceptance is intended, forward contracts should be recorded in the same manner as when-issued securities; otherwise they should be accounted for in the same manner as futures contracts. A forward sale that creates a naked (uncovered) short position should be accounted for as a short sale. It should be noted that a forward trade that offsets the economics of an existing contract may not eliminate the legal commitment to deliver or receive.

2.59 Because market quotations are not readily available for forward contracts, their fair values should be determined by the board of directors. In addition to the usual factors considered in valuing securities in good faith, the terms for the securities covered by the contract should be compared with the terms of similar securities if prices for those securities are readily available.

2.60 The valuation of forward placement commitments can result in recognition of an unrealized gain or loss each time the commitment is valued. Realized gains or losses are recognized when the transaction is completed or canceled.

Standby Commitments

2.61 A standby commitment is an optional delivery forward placement commitment. On sale of a standby commitment, an investment company is contractually bound to accept future delivery of a security at a guaranteed price or fixed yield on the exercise of an option held by the other party to the agreement. In effect, the investment company sells a put option and receives a fee for its commitment to buy the security. The investment company bears the risk of loss if interest rates rise, causing the price of the security at delivery date to be less than the exercise (strike) price of the option less the fee received. The fee received for committing to acquire securities under a standby commitment should be recorded in the liabilities section of the statement of assets and liabilities and adjusted to value, but not less than zero.[42]

2.62 Each time such a contract is valued, unrealized gains and losses are recorded in the amount that the value varies from the premium received. For example, if the current market value of the option exceeds the premium, an unrealized loss is recorded. A gain or loss is also recognized when the option is exercised or expires.

2.63 When an investment company acquires a standby commitment, it has in effect purchased a put option. Its risk of loss is limited to the fee paid for the standby commitment. The accounting for put options purchased, which is discussed in this chapter, should be followed.

(Footnote Continued)

agreement may involve the issuance of a security by the investment company. The security may be a senior security as defined in section 18(g) of the Act, and the investment company entering into the agreement may be in violation of section 18(f)(1). However, the Division of Investment Management has determined that it will not raise the issue of compliance with section 18 with the SEC if the investment company covers the senior security by establishing and maintaining certain segregated accounts.

[42] Ibid.

Put and Call Options

2.64 An investment company may buy or write put and call options, if permitted, as disclosed in the prospectus.[43] As consideration for an option, the buyer pays the writer a premium, the amount of which is determined in the exchanges' option markets based on supply and demand. That amount is influenced by such factors as the duration of the option, the difference between the exercise price and the market price of the underlying securities, price volatility, and other characteristics of the underlying securities. In return for the premium—

- A covered writer of a call option, a writer who owns the underlying securities, gives up the opportunity to profit from an increase in the price of the underlying securities to a point higher than the exercise price as long as the option obligation continues, but retains the risk of loss if the price of the securities declines.
- An uncovered writer of a call option, a writer who does not own the underlying securities, assumes the obligation to deliver the underlying securities on exercise of the option. An uncovered writer is exposed to the risk of loss if the price of the underlying securities increases, but has no risk of loss if the price of the securities decreases to a point lower than the option exercise price.
- A writer of a put option is exposed to the risk of loss if the market price of the underlying securities declines, but cannot profit from an increase in the market price because the holder of the option will not exercise it as long as he can obtain a greater price elsewhere; he is covered if he buys a put option on the same underlying securities with an exercise date equal to or later than the option it covers and an exercise price equal to or greater than the option written.

2.65 Premiums from writing put and call options should be presented in the liabilities section of the statement of assets and liabilities and subsequently adjusted to the current market value of the option written, but not less than zero.[44] For example, if the current market value of an option exceeds the premium received, the excess is an unrealized loss and, conversely, if the premium exceeds the current market value, the excess, to the extent of premiums received, is an unrealized gain.

2.66 After an option is written, the writer's obligation may be discharged in one of the following ways:

a. The option expires on its stipulated expiration date.

b. The writer enters into a closing transaction.

c. The option holder exercises the right to call (buy) or put (sell) the security.

If it is discharged the first way, the investment company option writer reports a realized gain to the extent of the premium received. If it is discharged the second way, the investment company option writer reports a realized gain or loss. A loss is reported if the cost of the closing transaction exceeds the premium received. If it is discharged the third way, an investment company covered call writer delivers the underlying securities that the writer had

[43] Chapter 4 discusses special tax rules.

[44] Current market value of options traded on exchanges should be considered the last sale price. Alternatively, the mean between bid and asked prices may be used in accordance with the valuation policy followed by the fund; if the bid price is higher or the asked price lower than the sale price, the higher bid or lower asked price may be used.

previously instructed its custodian to place in escrow with its broker in a segregated custody account with the custodian and each broker, and receives the exercise price; an uncovered call writer must buy or borrow securities for delivery to the exercising holder. For a covered writer, the difference between the proceeds of the sale plus the amount of the premium and the cost of the security should be accounted for as a realized gain or loss. For an uncovered writer, a realized loss from the simultaneous purchase and sale of the securities should be reduced by the premium. If the holder of a put option written by an investment company exercises the option, the investment company's cost basis should be the exercise price of the underlying securities plus commissions, reduced by the premium received.

2.67 The cost of portfolio securities acquired by exercising call options owned should be increased by the premium paid to buy the call. The proceeds from securities sold by exercising put options owned should be decreased by the premium paid to buy the put.

2.68 The writer or buyer of an option traded on an exchange can liquidate the position before the exercise of the option by entering into a closing transaction. Such a transaction, in effect, cancels the existing position. The cost of a liquidating purchase, however, may be higher than the premium received for the original option.

2.69 Because the writer or buyer can enter into a closing transaction, the option originally written may never be exercised. An option traded on an exchange is exercised only through the Options Clearing Corporation (OCC), the obligor on every option, by the timely submission of an exercise notice by the clearing broker acting on behalf of the exercising holder. The exercise notice is assigned by the OCC to a clearing broker acting on behalf of a writer of an option of the same series as the exercised option. The clearing broker is obligated to deliver the underlying security against payment of the exercise price. The assigned broker is selected randomly from clearing members having accounts with the OCC with options outstanding of the same series as the option being exercised.

2.70 Most investment companies deposit securities or cash underlying call or put options written in three-party special segregated custody accounts with their custodian and their broker to guarantee delivery or payment if the options are exercised.

2.71 Portfolio securities underlying call options written should continue to be reported at value determined in a manner appropriate to the underlying security.

2.72 Actively traded put and call options owned by an investment company should be accounted for in the same manner as marketable portfolio securities.

2.73 The fair value of options not listed or traded on a national exchange or not actively traded should be estimated in good faith by the investment company's board of directors. In estimating value, the board should consider such factors as the prices, volatility, and liquidity of the underlying securities and the time remaining to the expiration date.

Repurchase Agreements

2.74 A *repurchase agreement* (repo) [45] is an agreement under which, on payment of the purchase price, an investment company receives (purchases)

[45] The AICPA's June 1985 *Report of the Special Task Force on Audits of Repurchase Securities Transactions* discusses the background, form, and use of repurchase or reverse repur-

securities from a seller who agrees to repurchase them at or within a specified time at a specified price.[46] A repurchase agreement is similar in effect to a loan by the investment company to the seller collateralized by the securities. The investment company does not record the purchase of the securities received but does record the repurchase agreement as if it were a loan. Because a repurchase agreement between the two specific parties involved is generally for a relatively short time and is not transferable, it has no ready market. Investment companies generally carry repurchase agreements at cost, which, combined with accrued interest, approximates market. If unusual circumstances make adjustment of the carrying amounts of repurchase agreements necessary, the agreements should be reported as securities valued in good faith by the board of directors.

2.75 Repurchase agreements are usually entered into with banks, brokers, or dealers. In all cases, the investment company should be sure that the repo, including accrued interest, is fully secured by the value of the collateral it has received.[47] If a repurchase agreement is with a broker or dealer, the Fund's board of directors should evaluate the creditworthiness of the broker or dealer issuing the repo.[48] Generally, the board makes a similar evaluation about other entities with which the Fund enters into repurchase agreements.

2.76 A *reverse repurchase agreement* provides for the investment company to transfer possession of (sell) a security to a buyer, usually a broker, for cash.[49] The investment company does not record a sale of the security and it agrees to later repay cash plus interest in exchange for the return (repurchase) of the same securities; the transaction is thus similar in effect to a borrowing by the investment company collateralized by the security. The contract may be a daily contract that is continually renewed. The proceeds of the transaction should be recorded as if they were of a borrowing, and the security should continue to be recorded as if it were in the portfolio, though subject to lien, and should be valued in a manner suited to it.

Accounting for Foreign Investments

2.77 Investments in securities issued by foreign companies involve considerations not typically associated with investing in securities issued by domestic companies. Investments in certain foreign countries may be exposed to the possibility of expropriation or confiscatory taxation, limitations on the removal of funds or other assets, political or social instability, or adverse diplomatic developments. Individual foreign economies may differ from the economy of the United States in growth of gross national products, rates of inflation, capital reinvestments, resource self-sufficiency, and balance of payments positions. Securities of many foreign companies may be less liquid and their prices more volatile.

2.78 Because most foreign securities are not registered with the SEC, most of their issuers are not subject to its reporting requirements. Generally there is less government supervision and regulation of stock exchanges, brokers, and companies in foreign countries than in the United States. As a result, information concerning certain foreign issuers of securities may be less pub-

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(Footnote Continued)

chase agreements, the risks involved, and legal, accounting, reporting, and auditing considerations.

[46] Repurchase agreements, discussed in this guide, are known in the broker-dealer industry as reverse repurchase agreements.

[47] SEC Release No. 10666 under the 1940 Act sets forth the Commission's position that repurchase agreements should be fully collateralized. That is, "the value of the transferred security . . . is at least equal to the amount of the loan including accrued interest thereon."

[48] SEC Release No. 13005 under the 1940 Act.

[49] See footnote 45.

licly available. Also, foreign companies may not be subject to uniform accounting, auditing, and financial reporting standards or to practices and requirements comparable to those that apply to domestic companies.

Portfolio Transactions

2.79 Many foreign stock markets are not as developed or efficient as those in the United States. Fixed commissions on transactions on foreign stock exchanges usually are higher than negotiated commissions on U.S. exchanges. The times between the trade and settlement dates of securities transactions on foreign exchanges range from one day to four weeks or longer.

2.80 Foreign securities generally are denominated and pay dividends or interest in foreign currencies. The value of assets traded in foreign currencies is affected by changes in foreign exchange rates. Also, trading activities may be adversely affected by restrictions on the conversion or transfer of foreign currencies.

2.81 Foreign exchange transactions may be conducted on a cash basis at the spot rate for buying or selling the currency prevailing in the foreign exchange market. Under normal market conditions, the spot rate differs from the published exchange rate because of the costs of converting from one currency to another. Some funds deal in forward foreign exchange contracts between the dollar and currencies of various countries as hedges against possible changes in foreign exchange rates between currencies. They contract to buy specified currencies at specified future dates and prices set at the time of the contracts. Dealings in forward foreign exchange contracts may relate to specific receivables or payables occurring in connection with the purchase and sale of portfolio securities, the sale and redemption of fund shares, or the payment of dividends and distributions. Also, a fund may speculate in forward foreign exchange contracts. Hedging against a decline in the value of a currency does not eliminate fluctuations in the local currency prices of portfolio securities or prevent losses if such prices decline.

2.82 The cost of transacting in foreign currencies varies with such factors as the currency involved, the length of the contract period, and the prevailing market conditions. Because exchanges in foreign currencies are usually transacted by principals, most often there are no fees or commissions.

Dividends and Interest

2.83 Recording dividends on foreign securities is often difficult because, in certain countries, companies customarily declare dividends retroactively, claims may be made against the government for return of taxes withheld at the source, or there is a lack of timely information.

2.84 The auditor should determine whether the company's internal control structure reflects consideration of those difficulties and should also devise audit procedures to determine that net asset value is computed satisfactorily. Also, dividends and interest received from foreign investments may result in withholding taxes and other taxes imposed by foreign countries, generally at rates from 10 percent to 35 percent. Tax conventions between certain countries and the United States may reduce or eliminate such taxes. Foreign countries generally do not tax capital gains on investments by foreign investors.

2.85 Internal Revenue Code section 853 provides that if more than 50 percent of a fund's total assets at the end of its fiscal year consists of securities of foreign corporations, the fund qualifies for and may elect to permit its shareholders to take a credit or a deduction for foreign income taxes paid by the fund. That policy enables the shareholders to benefit from the same foreign tax credit or tax deduction they would have received had they been the individual owners of foreign securities and paid foreign income taxes on their income.

Valuation of Foreign Securities

2.86 In general, the discussion of valuation of securities in this chapter also applies to foreign securities. Portfolio securities that are primarily traded on foreign securities exchanges should generally be valued at the U.S. dollar equivalent of the preceding closing values for such securities on their exchanges. FASB Statement No. 8, *Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements,* Appendix D, paragraphs 219 and 220, specifically states that the FASB did not intend to require investment companies to disclose separately the portion of the change in market value that results from foreign currency rate changes. Even though that exception is not specifically mentioned in FASB Statement No. 52, *Foreign Currency Translation,* practice has continued to follow this approach.

2.87 The daily time at which a fund prices its portfolio is determined by its board of directors. The fund should consider additional information, if any, affecting changes in value after the close of foreign exchanges on which the portfolio's securities are traded. (For a further discussion on this matter, see "SEC Division of Investment Management No-Action Letter" of January 23, 1981, to the Putnam Growth Fund, Putnam International Equities Fund, Inc.)

Exchange Gains and Losses From Valuation of Currency Contracts and From Foreign Investment Transactions

2.88 Unrealized and realized exchange gains or losses result when investment companies whose financial statements are reported in U.S. currency do any of the following:

- Buy, sell, or hold foreign currencies
- Buy or sell portfolio securities denominated in foreign currencies
- Trade in forward foreign currency contracts
- Receive dividends and interest income in foreign currencies
- Incur expenses in foreign currencies

2.89 Foreign currency transaction gains and losses may be accounted for separately or may be combined for reporting purposes with the type of transaction that gave rise to the gain or loss. The latter method more closely follows the preferred tax treatment, and for that reason is favored by some companies. For example, a gain or loss on an amount payable that results from a change in the exchange rate of a foreign currency between the trade date and the settlement date for a security bought may be accounted for as an increase or decrease in the cost of the security (unless a forward foreign currency contract is purchased on the trade date for delivery on the settlement date). Similarly, an exchange gain or loss that occurs because of a change in exchange rates between the time a dividend or interest income is accrued and realized may be accounted for as an increase or decrease in the respective income account.[50]

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[50] Investment companies should disclose separately, in the financial statements or the notes, the aggregate amount of the transaction gain or loss, if material.

2.90 Reporting exchange gains or losses for financial statements may differ from reporting them for income taxes. Because of changes in case law and regulations in this area, the reporting company should seek current tax advice when it enters into foreign investment transactions that may result in exchange gains or losses.

Safekeeping of Foreign Assets

2.91 Funds invested in foreign securities generally involve custodial or subcustodial agreements with U.S. banks with foreign branches for the safekeeping of fund assets held outside the United States. Section 17(f) of the 1940 Act specifies the requirements and qualifications of a custodian for a registered investment company.

2.92 Rule 17f-5 permits registered investment companies to maintain their foreign securities with eligible foreign custodians (for example, foreign banks and trust companies that meet certain requirements, securities depositories, and clearing agencies). Rule 17f-5 sets forth the conditions that must be included in the foreign custody agreement, as well as the specific responsibilities of the investment company's board of directors in reviewing and approving the arrangements.

Accounting for Segregated Accounts

2.93 In certain circumstances, such as in the case of leveraging transactions, the SEC requires an investment company to maintain assets in segregated accounts. Such assets consist of cash, U.S. government securities, or other high-grade debt obligations, and may be replaced only by other similar assets. Securities maintained in such segregated accounts should be valued in the manner suited to them.[51]

Accounting for Short Securities Positions

2.94 Short securities positions should be accounted for at value. The difference between the net proceeds of the short sales and the valuations should be reported as unrealized appreciation or depreciation of the investments. The securities should be valued by a method suited to them, except that using bid prices alone is not acceptable.[52]

2.95 Amounts deposited with brokers for short sales of securities should be reported as assets. Proceeds from securities sold short should be reported as liabilities and marked to market. Gains and losses are classified as realized when a short position is closed out.

2.96 A short sale creates a senior security that is subject to the limitation of section 18 of the 1940 Act. To comply with the provisions of section 18, an investment company that sells securities short must establish a segregated account, as discussed in the section on accounting for segregated accounts, to account for cash or cash equivalents equal in value to the securities sold short or to equivalent securities already owned if the sale is against the box.

Purchase of Another Company's Investment Portfolio

2.97 An investment company may acquire the entire investment portfolio of another investment company in a business combination. The accounting for such transactions is discussed in chapter 8.

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[51] SEC Release No. 10666 under the 1940 Act.

[52] Guide 28, "Valuation of Securities Being Offered," *Guidelines for Form N-1A*, Investment Company Act Release No. IC-13436.

Accounting for Investment Income

2.98 An investment company's investment income consists of dividends and interest.

Dividends

2.99 Dividends on investment securities are recorded as of the ex-dividend date. Distributions that represent returns of capital usually are credited to the investment account rather than to income. Some investment companies treat distributions designated as returns of capital by the issuer, such as certain public utility dividends, as income for reporting purposes based on the theory that the return of capital designation is a tax concept that need not govern financial reporting. That treatment does not affect the amount reported as an increase in net assets resulting from operations. Chapter 4 discusses the tax treatment of dividends.

2.100 Stock splits and stock dividends in shares of the same class as the shares owned are not income to the investment company. However, dividends for which the recipient has the choice to receive cash or stock are usually recognized as investment income in the amount payable in cash, because cash in this case is usually the best evidence of fair value of the stock.

2.101 Other noncash dividends are recognized as investment income at the fair value of the property received, in accordance with APB Opinion No. 29, *Accounting for Nonmonetary Transactions.*

2.102 Cash dividends received on preferred stocks in liquidation of accumulated dividend arrearages should be reported as other income.

2.103 Stock rights received are generally allocated a prorated portion of the cost basis of the related investment; however, for book purposes, investment companies usually follow tax accounting, which does not require allocation if the market value of the rights is 15 percent or less of the market value of the investment company's holdings.[53]

2.104 SEC Regulation S-X requires cash dividends declared on stocks for which the securities portfolio reflects a short position as of the record date to be recognized as an expense on the ex-dividend date.

2.105 As a routine operating policy, investment companies should consult reliable published or other sources for daily dividend declarations and other corporate actions to be sure they obtain and record relevant dividend information in a timely manner. Companies should have procedures that provide for follow-up and for disposition of dividends not collected in the regular course of business because of delays in settling securities transactions or completing transfer procedures.

Interest

2.106 Interest income on debt securities, such as corporate, municipal, or treasury bonds, normally is accrued daily. Discounts on Treasury bills are usually amortized to interest income daily. Because an investment company carries its investments at value and reports both realized and unrealized gains and losses, accretion of discounts or amortization of premiums does not affect its net asset value or results of operations. For that reason, most investment companies adopt an amortization policy that conforms to the income tax regulations that apply to the fund.

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[53] Section 307 of the Internal Revenue Code.

2.107 An investment company should consider collectibility of interest in making accruals. If collectibility is doubtful, a valuation allowance should be established.

2.108 Interest received on bonds that were in default or that were delinquent in the payment of interest when acquired should be accounted for as (*a*) interest income for the amount earned from the date of acquisition through the current period, or (*b*) a reduction of the cost of the investment in terms of the amount relative to arrearages at the date of acquisition.[54]

2.109 The accrued interest receivable account should be analyzed at regular intervals to make sure that interest payments due are received promptly and in the correct amount. Similarly, the disposition of purchased interest receivable and interest accruals on debt securities sold between interest dates should be analyzed periodically.

Determining Costs and Realized Gains and Losses

2.110 The cost of investment securities in the portfolios of registered investment companies and net realized gains or losses from securities transactions are determined, for financial accounting purposes, on the specific identification or average-cost methods.[55] A company should use only one method for all securities. Cost includes commissions and other charges that normally are a part of brokers' purchase advices. The average-cost method of computing gains and losses may not be used for federal income taxes. Some companies try to avoid wide differences between net realized gains or losses from securities transactions reported on the average-cost basis and those reported on the identified-cost basis by identifying, to the extent possible, specific shares with aggregate costs near the average cost for shares being delivered against a particular sale.

2.111 An investment company may occasionally be entitled to receive awards from litigation relating to a portfolio company. An award should be reported at fair value, considering such factors as the enforceability of the right to settlement and the ability to determine the amount receivable. If the investment company holds the securities, the award generally is accounted for as a reduction of their cost. If the investment company no longer holds the securities, the proceeds generally should be accounted for as realized gains on security transactions.

2.112 An investment company may receive securities in a spin-off of a portion of a portfolio company's operations. Spin-offs are generally tax-free reorganizations, and no gain or loss is recognized for income tax or financial reporting. A portion of the cost of the securities held is allocated to the securities received in the spin-off. That amount is based generally on the ratio of the value of the securities received to the sum of the value of those shares and the value of the shares of the company effecting the spin-off.

2.113 From time to time, tender offers may be received for securities held by an investment company. The terms of the offer may be for cash, debentures of the acquiring company, stock of the acquiring company, or a combination thereof. Even if the investment company tenders its securities, it should continue to value the shares tendered until the number of shares accepted in the tender is known. Thereafter, it should value the assets to be received for the shares tendered.

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[54] SEC, *Codification of Financial Reporting Policies*, section 404.02.

[55] Rule 2a-2 of the 1940 Act.

2.114 Accrued interest on bonds bought between interest dates is accounted for as a receivable. Premiums paid for obligations of a state, territory, or possession of the United States or its political subdivisions are required to be amortized for federal income tax purposes. Many investment companies also amortize those premiums for book purposes. Original issue discount on bonds and other debt securities is frequently amortized for financial reporting purposes and is also required to be amortized for tax purposes. Discounts on the purchase of bonds that do not provide for periodic interest payments, sometimes called "zero coupon bonds," should normally be amortized to income by the interest method, unless another method produces substantially similar results. However, because investment companies carry securities at value, amortization of a premium or discount has no effect on net asset value. Amortization of a premium decreases interest income and increases unrealized appreciation of investments by the same amount. Amortization of a discount has the reverse effect. As a result, an investment company's amortization policy may affect net investment income but does not affect total income from investments, that is, net investment income plus realized and unrealized gains and losses.[56] The amortization policy and the method of deferring amortization should be disclosed in the financial statements. Accrued interest on bonds sold is accounted for as a reduction of accrued interest receivable and is not a factor in determining gain or loss on a sale.

Auditing Procedures

2.115 The audit of an investment company's investment accounts is a significant portion of the overall audit because of the relative significance of those accounts and of the related income accounts. In auditing the investment accounts, the auditor should consider various aspects of the investment company's transactions with brokers, custodians, and pricing services.

Principal Audit Objectives

2.116 The principal objectives in auditing the investment accounts are to determine whether—

- The company has possession of securities not held in safekeeping by others.
- Other entities holding securities for safekeeping are either qualified banks or other companies whose functions are supervised by federal or state authorities, and they agree with the company in their descriptions and quantities of securities being held in safekeeping.
- Transactions are authorized and recorded in the proper account, amount, and period.
- There is a reasonable assurance that the investment company has complied with restrictions under its stated investment objectives and policies.
- Portfolio investments are properly valued, and their costs are properly recorded.
- The company has ownership of and accounting control over its portfolio investments.

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[56] The total of realized and unrealized gains or losses represents changes in values of securities while they were held during the period. That amount consists of the appreciation or depreciation for the period for securities held at the end of the period, plus the appreciation or less the depreciation from the beginning of the period to the date the securities were sold during the period.

- Income from investments and realized gains and losses from securities transactions are properly accounted for.
- Investments are free of liens, pledges, or other security interests or, if not, such matters are properly identified and disclosed.

Consideration of the Internal Control Structure

2.117 Establishing and maintaining an internal control structure is an important management responsibility. In establishing specific internal control structure policies and procedures concerning an investment company's ability to record, process, summarize, and report financial data that is consistent with management's assertions embodied in the financial statements, some of the specific objectives management may wish to consider include the following:

- Transactions are executed in accordance with management's general or specific authorization.
- Transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or other criteria applicable to such statements and to maintain accountability for assets.
- Access to assets is permitted only in accordance with management's authorization.
- The recorded accountability for assets is compared with the existing assets at reasonable intervals, and differences, if any, are investigated.[57]

2.118 The second standard of fieldwork states that "A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed." Form N-SAR requires auditors of registered investment companies to report on their study and evaluation of an investment company's internal accounting controls, including those controls exercised on behalf of the company by agents acting as custodians. The report, which is filed with the year-end Form N-SAR, is based solely on the study and evaluation made as part of the audit.

2.119 The location of the investment securities should be ascertained by the independent auditor. The auditor should determine whether and to what extent the company and its board have evaluated their relationship with the securities' custodian in terms of significant record-keeping responsibilities, financial stability, operational capabilities, and other matters pertaining to the relationship. The auditor should obtain an understanding of the custodian's internal control structure to the extent he or she considers necessary to plan the audit and to determine the nature, timing and extent of tests to be performed. A custodian's control procedures that may be relevant to an audit of an investment company's financial statements might include, among others, the following:

- Procedures covering the receipt of and payment for securities, delivery of securities, and control over cash received.
- Procedures for physically segregating and satisfactorily safeguarding the company's securities in the custodian's vaults.
- Physical counts and other procedures performed by the custodian's internal auditors.
- Procedures for securities held in central depositories.

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[57] SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit,* Appendix D.

- Procedures concerning receipts of cash and other dividends and of interest.

2.120 If the custodian has engaged a service auditor to review and report on its internal controls over custodial functions, the fund's auditor should consider obtaining a copy of the service auditor's report. The auditor's use of third-party reviews is discussed in paragraphs 3.48 through 3.53 of chapter 3. Further guidance is provided by SAS No. 70, *Reports on the Processing of Transactions by Service Organizations,* which is effective for service auditor's reports dated after March 31, 1993.

2.121 An investment company may enter into subcustodial arrangements for investment in foreign securities with institutions both inside and outside the United States.[58] The auditor should review subcustodial arrangements to determine the extent of intercustodial responsibilities and rights. If the principal custodian bank does not assume responsibility for the foreign subcustodian's actions, and the portion of the fund's assets held by the foreign subcustodian is material in relation to the financial statements, the auditor should apply to each subcustodial arrangement audit techniques similar to those for principal custodians.

2.122 If an investment company enters into repurchase agreements, the auditor should consider whether the company's internal control structure policies and procedures include—

a. A review of the creditworthiness of the issuers of repurchase agreements with whom the company intends to do business.

b. A requirement that actual or constructive possession of the collateral be taken by the company, its custodian, or by a custodian qualified under the 1940 Act, who verifies that the collateral is being held for the company.

c. A requirement to mark the collateral to market daily during the entire period of the agreement.

d. A requirement that such agreements provide that additional collateral be deposited by the issuer if the market value of the securities falls below the repurchase price.[59]

2.123 The auditor should review such relevant investment company documents as the latest prospectus, certificate of incorporation, bylaws, and minutes of meetings. Typically the auditor tests whether the fund is adhering to its investment restrictions. For a diversified investment company, the auditor should review and test compliance with the related provisions of the 1940 Act. Other compliance areas that the auditor should review include, for instance, the 1940 Act's record-keeping requirements and compliance items to be reported in the annual report to the SEC on Form N-SAR. The auditor should consider that certain investment transactions may involve the investment company's issuance of senior securities as defined under section 18 of the Act. The auditor should be aware that the 1940 Act also contains restrictions on the issuance of senior securities under section 18.[60]

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[58] SEC Release No. 12354 under the 1940 Act.

[59] SEC Release No. 13005 under the 1940 Act.

[60] SEC Release No. 10666 under the 1940 Act.

Examination of Transactions and Detail Records

Custody of Securities

2.124 The independent auditor should confirm securities with the custodian, including securities held in a central securities system, or physically examine them. Under certain circumstances, physical examination of securities is required.[61] However, a securities count may be inconclusive because the auditor may be unable to identify specifically the securities belonging to the client. Because physical examination of securities often is not practical, confirmation procedures are most frequently used.[62] The auditor should confirm unsettled securities transactions with broker-dealers regardless of whether they are reported by the custodian. If a confirmation is not returned, the auditor should become satisfied with the authenticity of the transaction by applying alternative auditing procedures.

2.125 Other confirmation procedures typically include confirmation of—

- When-issued transactions with the underwriter, including the value of when-issued transactions as of the valuation date.
- Commodity futures contracts and financial futures contracts with the contract's dealer, from whom the contract was acquired.
- Forward placement commitment contracts, standby commitment contracts, and repurchase agreements with the other party to the transaction. For forward placement commitments, standby commitments, and reverse repurchase agreements, the independent auditor should review the contracts or agreements and consult with the investment company's legal counsel to determine if a senior equity security, as defined in section 18(g) of the 1940 Act, exists.
- Short securities positions with the broker.
- Borrowed or loaned securities and related collateral.
- Put or call options with the company's custodian, broker, or other party to the transaction.

2.126 Specific inspection procedures required under the 1940 Act depend on the type of custodial arrangement.[63] If the custodian is a member of a national securities exchange, the 1940 Act and the related rule 17f-1 require the investment company's independent auditor to inspect all securities at the end of each annual and semiannual fiscal period and at least one additional time during the fiscal year chosen by the auditor, without advance notification to the custodian. If the investment company retains possession of its securities, the company's independent auditor should physically inspect the securities at least three times in each fiscal year. The dates for at least two of the inspections should be chosen by the auditor without notice to the investment company.[64] After each audit, the independent auditor should address a report to the client's board of directors. The auditor is required to promptly submit a copy of that report to the SEC stating that such an audit was performed and describing the work done and the results. An illustration of such a report is provided in chapter 9.

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[61] SEC, *Codification of Financial Reporting Policies*, section 404.01.a.

[62] Section 17(f) of the 1940 Act.

[63] Ibid.

[64] Rule 17f-2 of the 1940 Act.

Tests of Portfolio Transactions

2.127 The independent auditor, rarely considering it necessary to examine all transactions during the period under audit unless specifically requested to do so, normally selects portfolio transactions for testing. Representative purchase, sale, and exchange transactions, and brokers' advices or other documents should be examined to ascertain that they agree with the entries recorded in the purchase, sales, or general journals or other books of original entry. The auditor should test for proper authorization, extensions, and trade dates. To confirm that the price appears to be reasonable, the auditor should consult published sources. The auditor should also test whether sales have been properly accounted for during the period, that an acceptable method of costing sales (specific identification or average-cost) has been applied consistently, and that gains or losses have been properly calculated. If restricted securities were sold or otherwise disposed of, the auditor should inquire whether the company has complied with rule 144 of the 1933 Act and with any other pertinent laws. Rule 144 applies to all holders of restricted securities, not only to registered investment companies.

2.128 The independent auditor should also test the classification of gains and losses for tax purposes and the adjustments to the carrying amount of investments resulting from stock dividends, splits, rights, recapitalizations, and liquidating dividends. (Chapter 4 discusses taxes.)

Portfolio Transactions With Affiliates

2.129 The auditor should become familiar with section 17 of the 1940 Act and with related rules that contain certain prohibitions concerning transactions with affiliates. Regulation S-X requires disclosure of more information about transactions with affiliates in prospectuses and annual reports to the SEC than is required in GAAP financial statements. Various rules of Regulation S-X require the financial statements of an investment company to state separately investments in, investment income from, gain or loss on sales of securities of, and management or other service fees payable to controlled companies and other affiliates. The term *affiliate* means an affiliated person as defined in section 2(a)(3) of the 1940 Act, and the term *control* has the meaning given in section 2(a)(9) of the Act. The term *affiliated person* as defined in section 2(a)(3) of the Act encompasses control relationships and the direct or indirect ownership of 5 percent or more of the outstanding voting securities of any issuer. An affiliated person, as defined in that section, includes officers, directors, partners, employees, investment advisers, and members of the investment adviser's advisory board.

2.130 In ascertaining whether such affiliations exist, the auditor should consider the information gathered during the audit and should inquire of the company's management. As evidence of these inquiries, the auditor should obtain written representations from management that, except to the extent indicated, the company—

- Does not own any securities either of directly affiliated or, to the best information and belief of management, indirectly affiliated entities.
- Has not received income from, or realized gain or loss on sales of, investments in or indebtedness of such entities.
- Has not incurred expenses for management or other service fees payable to such entities.
- Has not otherwise engaged in transactions with such entities.

Appendix F presents an illustrative representation letter. If there is a question of whether a relationship represents an affiliation, the company's management should obtain a written opinion from legal counsel for the auditor.

2.131 If there are affiliated entities, such as an underwriter or investment adviser, such auditing procedures as confirmation of transactions, examination of supporting documents, and written representations from the management of affiliated entities may be needed. These procedures are necessary because the fund is required, by rules under the 1940 Act, to disclose amounts paid to affiliates in connection with their services to the investment company, such as commissions for sales of fund shares and brokerage commissions for fund portfolio transactions. If the auditor of the investment company is not the auditor for the affiliated entities, audit procedures are facilitated if the auditor is granted access to the pertinent accounting records of those entities. Alternatively, the auditor may request that the affiliated entity engage its auditors to perform the necessary procedures.

2.132 The auditor should also be guided by the standards for related party transactions discussed in SAS No. 45, *Omnibus Statement on Auditing Standards—1983*, "Related Parties," and in FASB Statement No. 57, *Related Party Disclosures.*

Income From Securities

2.133 The auditor should select an acceptable method for testing investment income. Acceptable methods may include testing a sample of dividends and interest earned during the period, applying analytical procedures, or a combination of those methods. For example, in the auditor's tests of purchases and sales, the auditor may check the income for the entire year from the securities selected or, in conjunction with other procedures, may select an interim period and test the income earned during that period from a representative sample of securities. The auditor should consult independent financial reporting services to determine the ex-dividend and payable dates and the rates for the securities selected for testing. Interest payment dates and rates are also available from those services. The auditor should test the amortization of discounts on short-term discount securities, which generally are amortized to accrue interest income ratably over the periods to maturity.

2.134 In connection with his detailed testing, the auditor should consider unusual amounts of dividends (such as dividends in arrears) or interest (such as defaulted interest) received during the period under audit that may require special disclosure. The auditor should be satisfied that the accounting is proper for significant income from noncash dividends. The auditor should review the investment schedule at the date of the financial statements for nonincome-producing securities, as that term is defined in Regulation S-X, to determine whether such securities are identified in the schedule of portfolio securities in filings with the SEC. The auditor should test the company's determination of the tax status of dividend income.

2.135 Investment income from sources other than dividends or interest normally should be disclosed separately. The nature and significance of such items determine the extent of auditing procedures required.

Net Asset Value

2.136 The auditor's tests of net asset value as computed on the company's price makeup sheet at the financial statement date and on selected interim dates should normally include procedures that—

a. Compare against the investment ledger the quantities and descriptions of portfolio securities owned.

b. Trace quoted market prices to independent sources and to supporting documentation for investments stated at fair values, as determined by the board of directors.[65]

c. Test the clerical accuracy of valuation extensions and footings.

d. Reconcile amounts of assets and liabilities to the general ledger accounts. (If it is impractical to post daily in the general ledger, a company may use worksheets instead; if they do, the worksheets should be reconciled to the general ledger at the nearest month-end or other closing date.)

e. Review the reasonableness of income and expense accruals.

f. Reconcile the number of shares outstanding to the capital stock accounts in the general ledger or substitute worksheet.

g. Calculate the net asset value per share by dividing the difference between total assets and total liabilities by the number of shares outstanding.

2.137 The extent of the auditor's tests of net asset value computations depends on, among other factors, the auditor's assessment of control risk.

Valuation of Securities

2.138 The auditor should test all portfolio valuations as of the date of the financial statements.[66] In addition, because periodic computations of net asset value are based on portfolio valuations, the auditor should test transactions on dates selected from the period under examination for agreement with the values computed by the company. The extent of those tests should be based on the auditor's judgment and on his or her assessment of control risk.

2.139 The methods used to value investment securities are usually fixed in the bylaws or by action of the board of directors. The methods used by registered investment companies should conform with the 1940 Act. The auditor should determine whether the valuation method used conforms with the company's stated policy and, if applicable, with the rules of regulatory authorities. If values have been based on prices on a national securities exchange or on the over-the-counter market, the auditor should compare the values used to quotations provided by a reliable quotation service such as NASDAQ, a financial publication, or another independent source. There are situations in which it may be necessary to obtain quotations of prices from more than one independent source. If the auditor finds that the quotations tested for the valuation date differ significantly from the values used, he or she may wish to obtain further quotations at a previous or subsequent date or dates or consider having the security valued by the board of directors.

2.140 The fund's management is responsible for determining values of portfolio securities in accordance with the fund's policies. Most tax-exempt municipal bond funds use bond dealers or other pricing services to value their portfolios for a fee. If such agents are used, the auditor should consider whether control procedures maintained by the fund or by the pricing service provide reasonable assurance that material pricing errors would be prevented or detected. Such control procedures might include—

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[65] SEC, *Codification of Financial Reporting Policies,* section 404.03.c.
[66] Ibid.

- Checking methods used by the pricing service to obtain daily quotations.
- Verifying daily changes of individual securities prices in excess of a stipulated percentage.
- Verifying dealer quotations with other dealers on a test basis.
- Maintaining a comparison of actual sales prices with the value assigned for the preceding day.

2.141 The auditor might consider obtaining independent quotations from dealers or visiting the pricing service's facilities to review the procedures used to determine values. If the pricing service employs service auditors to report on its controls, the auditor should consider using the service auditor's report following the guidance in SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations.* SAS No. 70, *Reports on the Processing of Transactions by Service Organizations,* supersedes SAS No. 44 and is effective for service auditor's reports dated after March 31, 1993.

2.142 If the investment company uses matrix pricing to determine fair value, the auditor should do the following on a test basis:

a. Review the matrix used.

b. Determine that the results have been reviewed for reasonableness.

c. Compare sales proceeds from securities sold during the year to the value used on several days before the sale.

2.143 In addition, the auditor should consider using a second matrix and obtaining quotations from market makers, both for comparison.

2.144 The independent auditor does not act as an appraiser for security values estimated in good faith by the board of directors, and is not expected to substitute his or her judgment for that of the fund's directors. Instead, the auditor should review the company's procedures for its continuing appraisal of such securities, determine whether the methods established for valuation are followed, and make certain that these methods have been reviewed and approved currently by the board of directors. The auditor should review the procedures applied by the directors in valuing such securities, and inspect the underlying documentation to determine whether the procedures are reasonable and the documentation appropriate for that purpose. The auditor should also become familiar with the provisions of the SEC's financial reporting releases on this subject, especially section 404.03.

2.145 Good faith security value estimates may present the auditor with unique reporting problems. As previously discussed, securities should be stated in financial statements at amounts that represent what could have been realized on a current sale. In the absence of a bona fide offer to buy, those amounts are generally not determinable for securities that do not have readily ascertainable market values. The board of directors' fair valuation procedures are designed to approximate the values that would have been established by market forces and are therefore subject to uncertainties.

2.146 The uncertainty itself should not cause a modification of the auditor's opinion if the auditor concludes, based on examination of the available evidence, that the process used to estimate value is reasonable, the documentation is appropriate, and the range of possible values is not significant. The auditor may, however, choose to add an explanatory paragraph to the standard report to emphasize the matter as described in paragraph 37 of SAS No. 58, *Reports on Audited Financial Statements.* If the range of possible values is significant, normally the auditor's opinion should be modified because the financial statements do not include such possible material adjustments as might have been required had ready market values existed. An example of an independent auditor's report on financial statements modified as a result of such matters is presented in chapter 9.

2.147 If the audit discloses that the valuation procedures used by the board of directors are inadequate or unreasonable, or that the underlying documentation does not support the valuations, the auditor's opinion should be modified for lack of conformity with generally accepted accounting principles. The modification would include the phrase "except for." Depending on the significance of the misstatement to the financial statements, the auditor may determine that an adverse opinion is appropriate.

Chapter 3

Capital Accounts

3.01 Chapter 3 deals primarily with operations, controls, and accounting and auditing matters affecting the capital accounts of open-end investment companies. Most transactions affecting the capital accounts of closed-end investment companies can be accounted for and audited similarly to other commercial enterprises.

Operations and Controls

Distributors

3.02 As stated in chapter 1, a separate distributor organization, often referred to as the principal underwriter, sells shares of a load fund. Many no-load funds sell their shares directly to the public. The operations of distributors vary somewhat, so their accounting control requirements vary. Wholesale distributors sell shares to retail broker-dealers, who sell them to individual investors. Retail distributors sell shares directly to individual investors. In wholesale distributions, the commission, known as the load, is divided between the distributor and the broker-dealer; in retail distributions, the distributor retains the entire commission. In each of those transactions, the salesman selling the shares receives a portion of the commission. The salesman may be an independent contractor or an employee of the distributor or the retail broker-dealer. Some distributors are principals in the sales; they buy the shares from the fund and sell them to the investor or the broker-dealer. Other distributors are agents in the sales, which are made directly by the fund to the broker-dealer or the investor.

3.03 Sales commission rates on mutual funds generally decline as the amount of the sale increases. Some funds offer a letter of intent, right of accumulation, or other arrangement entitling a purchaser to a reduced sales charge based on the purchaser's aggregate purchases of fund shares.

3.04 The auditor should become familiar with arrangements for reduced sales charges, as described in the fund's prospectus.

Orders to Purchase or Repurchase

3.05 The fund or its agent—that is, transfer agent or principal underwriter—may receive orders from broker-dealers and individuals by telephone, wire, or mail to purchase mutual fund shares. Acceptance of orders is based on satisfactory credit checks and compliance with qualification requirements of the Blue Sky laws of the various states. Purchase orders not accompanied by cash payments require settlement within the normal period for settling purchase transactions.

3.06 The transfer agent commonly holds book shares on deposit in the name of an investor, though the investor may receive a stock certificate on request. Stock certificates generally are issued only in whole-share amounts; book shares may be maintained in fractional shares.

3.07 Investors buy at an offering price, which, for load funds, consists of the net asset value received by the fund plus a sales charge received by the principal underwriter. Investors generally redeem at net asset value, though in some instances a fund may charge redemption fees, which, to the extent received by the fund, are usually credited to capital. Orders accepted by the fund or its agent are executed at prices based on the net asset value per share that is first computed after the order is accepted (forward pricing)[67] and are time-stamped when received to substantiate the price. Funds have adopted a variety of ways for shareholders to redeem their shares, including the use of debit cards, automatic teller machines, check writing, wire orders, and telephone redemption procedures. The auditor should become acquainted with the particular methods described in the fund's prospectus. Confirmations of share transactions are sent to investors.

3.08 Accurate recording of sales and repurchases of fund shares depends on the adequacy of the distributor's, the fund's, and the transfer agent's controls over order processing.[68] The accuracy of the information about the investor, the number of shares, and dollar amount, which is on the order tickets, depends mainly on the reliability of the distributor's information.

3.09 Certain types of funds, particularly money market funds, sell or repurchase a large volume of shares in periods of fluctuating interest rates. The number of shares sold or repurchased may be affected by the fund's requirements for minimum account balances or minimum transaction amounts. The transfer agent's accounting controls over such activities as check writing, wire transfers, and telephone redemptions should be adequate to support periods of heavy volume.

3.10 The fund is responsible for establishing criteria for honoring redemptions. Funds usually do not honor redemptions unless purchases by personal check were made a prescribed number of days before redemption or purchases were made by federal funds. One control procedure should provide for identification in all accounts of amounts and dates of purchases by personal checks.

3.11 The basic accounting data about capital account transactions are recorded in sales and repurchase journals. In addition, to meet SEC disclosure requirements and state Blue Sky regulations, the sales journal may contain the source of the order by dealer (generally load funds only), sales statistics by area, the size of the order, and other share data.

Cancelation of Orders

3.12 A sale or repurchase occasionally may be canceled by an investor or broker-dealer before the settlement date. A change in net asset value per share between the sales date and the cancelation date results in a gain or loss to the fund. If a distributor is involved, and cancelation results in a loss, the distributor bears the loss or collects cash from the broker-dealer in the amount of the loss. If the cancelation results in a gain, the distributor may accrue the gain to offset losses from future cancelations and periodically settle the next losses with the fund. If no distributor is involved, as when a fund sells its shares directly to investors, the fund should consider refusing to accept sales orders not accompanied by payment, unless a responsible person has indemnified the fund for the failure to pay. Except for preauthorized expedited redemption procedures, the fund should also consider accepting orders for repurchases only if the stock certificates or written requests for book shares are properly endorsed and the signatures guaranteed by an appropriate organization, unless indemnified by a responsible person against failure to complete the transaction.[69]

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[67] Rule 22c-1 of the 1940 Act.

[68] Although the terms *repurchase* and *redemption* may have different legal meanings, they are used interchangeably in this guide, and are defined in the glossary.

[69] SEC Release No. 6366 under the 1940 Act.

Stock Transfers

3.13 Because of the continual sale and repurchase of fund shares, stock transfers are an integral part of a mutual fund's operations and are more complex than stock transfers of usual commercial entities. The records for total shares outstanding, total shares issued, and detailed shareholder accounts are kept current at all times. Mutual fund stocks generally are transferred by in-house operation (an affiliated company of the fund's manager or distributor), the separate department of a bank, or an independent servicing agent. The basic operations of all funds are the same; however, depending on the type of agent, the methods used by the funds or their managers to control stock transfers vary.

3.14 A fund and its distributor depend on information provided by the transfer agent's daily statement to record, in their records, sales and redemption orders sent by investors directly to a transfer agent. The transfer agent's daily statements show the day's activity both in shares and in dollars and should be reconciled to the fund's records to promptly identify and satisfactorily account for differences. A significant difference in the number of shares outstanding could affect net asset value per share.

3.15 Cash to settle transactions received by the fund, its distributor, or its transfer agent is forwarded to the custodian bank. Cash for redemptions usually is disbursed by the transfer agent to the investor or broker-dealer. Under arrangements in which the distributor and the fund do not handle cash, the fund depends on the transfer agent to provide information on paid and unpaid sales and repurchases. Sales of stock usually are settled within ten days, and redemptions usually within seven days. Either the transfer agent or the fund manager, depending on the arrangement, follows up on delinquent accounts receivable and unpaid repurchase orders.

3.16 The fund should determine that the number of outstanding shares shown on the fund's general ledger and the transfer agent's control account agree, and that the detailed shareholder accounts are posted currently. Items that require close attention include transactions in the control account not yet applied to the detailed shareholder accounts (suspense accounts) and errors in posting to individual shareholder accounts, including postings to incorrect accounts. To maintain proper control over those areas, it may be necessary for the fund to periodically review the transfer agency operation on site in addition to monitoring it continuously. The review often includes an inspection of the file containing shareholders' correspondence and inquiries; this file must be maintained by the company or its transfer agent. A significant volume of complaint letters may indicate problems in the detailed shareholder accounts.

3.17 A shareholder in an investment company generally may choose to receive distributions from investment income and net realized gains from securities transactions in cash or in additional capital shares. Such payments are usually made by the transfer agent. Internal Revenue Service regulations may require tax withholding on certain distributions. In addition to distributing cash or shares, the transfer agent generally is responsible for preparing and mailing annual distribution taxability notices to all shareholders. To be sure of proper handling, the fund should transmit such information to the transfer agent on a timely basis.

3.18 Money market funds generally declare and accumulate distributions daily for each account and usually distribute them in cash or additional shares monthly. The fund or its transfer agent mails periodic confirmation statements to the shareholders showing the cash distribution or additional shares credited to the account.

3.19 Accounting for treasury stock is significant for commercial entities and for certain closed-end investment companies. It is less important to mutual funds because only the total number of shares outstanding is relevant in their financial statements, and the number of shares previously repurchased by a fund is important only in connection with certain requirements of regulatory authorities. The SEC as well as state authorities have varying requirements for registration of shares sold in their respective jurisdictions. Sections 24e and 24f of the 1940 Act permit retroactive registration, under the 1933 Act, of shares sold in excess of shares registered, and also permit registration of an indefinite number of shares. A fund therefore needs to keep adequate records of the number of shares registered and the number and dollar amounts of shares sold in various jurisdictions. It also needs to make the required filings within the time permitted under regulatory statutes.

3.20 The 1940 Act specifies certain record-keeping requirements, and the SEC's staff periodically inspects the records for compliance.[70]

Accounting for Capital Share Transactions and Distributions

3.21 Accounting for shareholder transactions of mutual funds generally is the same as accounting for commercial entities. Sales of fund shares are recorded daily by crediting capital stock for the par value of the stock to be issued and additional paid-in capital for the amount paid over the par value; repurchases are recorded daily by debiting those accounts. To maintain a constant amount of undistributed net investment income per share, some funds use equalization accounting, which is discussed in chapter 1.

3.22 Investment income and realized gains on securities transactions and their distributions generally are accumulated in separate accounts. Proper recording of distributions depends on, among other things, proper recording of the number of outstanding shares.

3.23 Because of the significance of the relationship between net asset value and the market price of the company's stock, most closed-end investment companies record the distribution liability on the ex-dividend date rather than on the declaration date. Open-end companies record the liability on the ex-dividend date (in their case, the same as the record date) to properly state the net asset value at which sales and redemptions are made.

3.24 Shareholders of investment companies that offer the right to reinvest distributions—that is, receive distributions in additional shares—usually notify the company at the time they make their first purchase of shares of their intention to accept cash or to reinvest future distributions. A company establishes a valuation date for reinvestment of a distribution. The valuation date is often the day after the ex-dividend date. For both closed-end and open-end funds issuing shares at net asset value, the valuation date is the date at which the issuance of additional shares must be recognized in the accounts. Although the payment date is significant to those receiving the distribution in cash, the valuation date is important to those electing to reinvest the distribution in additional shares. At the valuation date, the actual or, if necessary, estimated number of shares to be issued and the price per share for reinvestment are set. The total net assets reflect the total dollars reinvested and the additional shares outstanding resulting from the distribution reinvestment.

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[70] Section 31 and rule 31a-1 of the 1940 Act.

Auditing Procedures

Principal Audit Objectives

3.25 The tests of the capital accounts (shareholder accounting) of a mutual fund cover a broad area encompassing various aspects of transactions with shareholders. The principal audit objectives are to test that—

a. The number of outstanding shares of capital stock at the audit date are properly stated.

b. Procedures are satisfactory for determining the number of outstanding shares used to compute daily net asset value per share.

c. Procedures are satisfactory for determining the number of shares required to be registered under the 1933 Act.

d. The receivable for capital stock sold and the payable for capital stock redeemed are properly stated.

e. Distributions from investment income and net realized gains from securities transactions and their reinvestment are properly computed and accounted for.

f. Procedures are satisfactory for maintaining control over the record-keeping for individual shareholder accounts.

Consideration of the Internal Control Structure

3.26 The independent auditor should become familiar with the following:

a. The rules and regulations under the 1940 Act covering shareholder accounting, including pricing of fund shares and record-keeping requirements

b. The fund's current prospectus, which states the fund's policies for accepting sales orders and redemption of fund shares

c. Provisions of the agreement among the fund, its distributor, and those responsible for the stock transfer function

d. State Blue Sky laws and the fund's procedures for monitoring compliance

3.27 The auditor should understand the shareholder accounting and transfer function, whether performed by the fund or outside agents. (See the discussion in this chapter on third-party reviews of outside service organizations.) The auditor might consider reviewing the procedures for controls over processing of the following:

a. Sales

b. Repurchases

c. Reinvestments

d. Payments of distributions

e. Distributions of shares

f. Correspondence

g. Stock issuance

h. Letters of intent

i. Transactions subject to rights of accumulation

j. Collections on sales and repayments for repurchases

k. Cancelation of sales and repurchases

l. Check writing and telephone redemptions

3.28 If the procedures for the above are implemented properly, the fund or its agent would be furnished promptly with the information required to properly process its shareholder records as required by the 1940 Act.[71] The auditor might consider procedures for and controls over inactive accounts (for example, dormant or undeliverable).

3.29 Administrative arrangements providing for such services as sub-transfer agency and record-keeping may exist among the fund, its custodian, transfer agent, or underwriter. The auditor should review the contractual responsibilities under those arrangements to determine whether to review the operations and accounting controls of the parties to those arrangements.

3.30 Based on his or her understanding of the internal control structure, the auditor may decide to obtain evidential matter about the effectiveness of both the design and operation of policies and procedures to support an assessment of control risk at a level lower than the maximum. Such evidential matter may be obtained from tests of controls.

3.31 The auditor may select transactions throughout the audit period to test controls in—

a. Retention of account applications.

b. Time-stamping of order documents.

c. Pricing at net asset value next computed.

d. Approval for credit.

e. Review and approval of daily transaction totals.

For those assertions for which the auditor performs additional tests of controls, the auditor determines the assessed level of control risk that those tests will support. This assessed level of control risk is used in determining the appropriate detection risk to accept for those assertions and, accordingly, in determining the nature, timing and extent of substantive tests for such assertions.

3.32 The independent auditor may wish to review schedules maintained by the fund of sales of shares in each state in connection with Blue Sky laws to test compliance with regulatory requirements or to determine that management is monitoring such compliance.

Examination of Transactions and Detail Records

3.33 The independent auditor performs substantive tests of the capital accounts activity and balances based on a number of factors, including the assessed level of control risk.

Sales and Repurchases of Fund Shares

3.34 The independent auditor may wish to test whether details on the order form or other customer evidence used in processing a sale or repurchase agree with the copy of the confirmation form ultimately sent to the shareholder to confirm the sale or repurchase. Such tests should also determine that the transactions conform with the fund's prospectus and with the reinvestment and redemption options selected by the shareholder in his or her account application.

3.35 Depending on the method used to repurchase shares, the auditor may examine shareholder requests, wire order forms, telephone tape recordings, telephone order forms, and copies of checks remitted to shareholders.

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[71] Rules 2a-4 and 31a-1 of the 1940 Act.

3.36 The auditor should test totals of daily sales and repurchases of capital shares by comparing them to postings in the related journals. Capital stock outstanding for the days tested should be compared against the applicable daily net asset valuation worksheets used as the bases for computing the net asset value per share.

Settlement of Sales and Repurchase Transactions

3.37 The independent auditor should become satisfied that procedures are in effect to determine that receivables for shares sold are collected and shares repurchased are paid promptly in accordance with regulatory requirements. Subsidiary trial balances of receivables and payables should be reconciled with general ledger control accounts as of the audit date. The timely cancelation of sales and repurchases not settled within a specified time and the disposition of losses that may result should also be determined.

Reconciliation of Shares Outstanding

3.38 The independent auditor should become satisfied that the fund has reconciled its general ledger account for outstanding shares with reports of the transfer agent throughout the audit period and satisfactorily resolved all reconciling items. The independent auditor should examine the underlying support for the reconciling items to the extent considered necessary.

3.39 At the audit date, the independent auditor should confirm shares outstanding directly with the transfer agent and should determine that the shares have been reconciled with the shares shown as outstanding in the fund's records. The independent auditor may sometimes consider it desirable or necessary to confirm outstanding shares directly with the shareholders.

Dividends to Shareholders and Reinvestments

3.40 Payments of dividends on capital stock may be tested to determine that payments in cash or in additional capital stock have been properly computed. Dividends based on long-term realized gains from security transactions, except for a supplemental distribution of up to 10 percent of the original distribution, may not be paid more than once a year.[72] Dividends should be reviewed for compliance with the 1940 Act.

3.41 The independent auditor should review the board of directors' minutes for relevant dates and amounts of dividend declarations and should test whether shares outstanding on that date (ex-dividend date for open-end companies), according to the fund's records, have been reconciled to information reported by the transfer agent. The total dividend should be recomputed (outstanding shares times rate) and compared against a notification from the dividend-paying agent, who is usually also the transfer agent. To test that the liability for a dividend selected for testing was recorded on the proper date, it should be traced to the general ledger and to the applicable daily net asset valuation worksheet. The computation of the number of shares to be reinvested, as reported by the dividend-paying agent, should be tested, and the portion of the dividend taken in shares should be compared against the capital stock accounts for agreement of both number of shares and dollar amounts.

3.42 The computations for funds that declare dividends daily should be tested for selected dates throughout the period.

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[72] Section 19 and rules 19a-1 and 19b-1 of the 1940 Act.

Record-keeping for Individual Shareholder Accounts

3.43 Based on the assessed level of control risk for assertions that relate to the activities of the transfer agent or shareholder servicing agent, the auditor may wish to select some accounts to test the validity and proper documentation of transactions for name and address changes, share transfers to or from individual accounts, and transactions that are not routine. The auditor may find it desirable to confirm some shareholder accounts.

Other Matters

3.44 If equalization accounting (discussed in chapter 1) is in effect, the auditor may test the calculation of equalization amounts.

3.45 Written complaints from shareholders received by the fund or transfer agent should be reviewed on a test basis. A significant volume of complaints relating to pricing or incorrect calculations of shares issued may require the independent auditor to extend testing.

3.46 The independent auditor may wish to confirm balances receivable for capital stock sold and balances payable for capital shares to be redeemed by the fund directly with the investor or the dealers who sell the fund's shares. Details of specific capital stock transactions may also be confirmed. Other normal alternative auditing procedures may be used to satisfy the auditor concerning receivables and payables for fund shares sold and redeemed.

3.47 Management's representation letter should state that fund shares were sold and redeemed in accordance with the fund's prospectus, the SEC's rules and regulations, and state securities regulations.

Third-Party Reviews of Outside Service Organizations

3.48 If a fund uses a service organization, such as an outside transfer agent or custodian, transactions that affect the fund's financial statements may flow through an accounting system that is, at least in part, physically and operationally separate from the fund's organization. Accordingly, controls and procedures at an outside service organization may be an integral part of the fund's controls and procedures. In deciding whether to rely on the fund's internal accounting controls, the auditor should consider the division of control procedures between the fund and the service organization. The auditor should identify significant classes of transactions processed by the service organization and gain an understanding of the flow of transactions through the system, including the portion maintained by the service organization. The auditor can evaluate the service organization's controls by obtaining and evaluating a service auditor's report that includes compliance testing and an evaluation of the design of the service organization's system, or by performing compliance tests directed to specific internal accounting control objectives. If the service auditor's report does not address controls on which the fund's auditor intends to rely, the fund's auditor may arrange for the service auditor to report on the results of applying agreed-on procedures to test compliance with those controls or may perform his or her own compliance tests at the service organization.

3.49 For example, if the service organization needs specific authorization for individual transactions, the fund can maintain independent records of transactions executed by the service organization and is normally able to maintain controls over those transactions. In such cases, the fund's auditor may wish to test compliance with those controls to establish a basis for reliance in determining the nature, extent, and timing of audit procedures.

3.50 Conversely, if the service organization is authorized to execute transactions without fund approval of individual transactions (for example, a transfer agent receiving purchases and redemptions directly from investors), the fund may not have independent records, and therefore its management will have to be sure that the internal control procedures at the agent level are sufficient to meet its objectives relating to transactions. In those circumstances, if the auditor wishes to restrict the nature, extent, and timing of the substantive audit procedures, he or she needs to test compliance with the controls at the service organization. Alternatively, paragraph 18 of SAS No. 44,* *Special-Purpose Reports on Internal Accounting Control at Service Organizations*, states that the auditor should "obtain a service auditor's opinion on the system of internal accounting control of the segment of the service organization that executes client organization transactions, or, if such a segment of the service organization is not distinguishable, a service auditor's report that covers both the design of the service organization's system and compliance tests that are directed to specific objectives of internal accounting control."

3.51 Although a service auditor's review of the service organization may reduce the efforts of the fund's auditor to evaluate compliance with internal accounting controls, it does not eliminate the responsibility of the fund's auditor to perform substantive tests.

3.52 SAS No. 44 * provides guidance on the use of the work of service auditors. To evaluate a service auditor's report, the fund's auditor should follow that guidance. The fund's auditor may wish to discuss with the service auditor the scope and results of his or her work, including the definition of materiality, for a better understanding of the procedures and conclusions.

3.53 The auditor should not refer to the report of a service auditor in the report on the fund's financial statements, because a service auditor is not responsible for auditing a portion of the financial statements at a specific date or for a specific period. The user auditor should refer to paragraph 23 of SAS No. 44 * for guidance if the period covered by the service auditor's report does not coincide with the period covered by the investment company's financial statements. If the auditor wishes to use a service auditor's report in an engagement to express an opinion on the fund's system of internal accounting control, he or she should refer to paragraph 25 of SAS No. 44.*

* SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*, supersedes SAS No. 44 and is effective for service auditor's reports dated after March 31, 1993.

Chapter 4

Taxes

4.01 This chapter is intended as guidance to the auditor and should not be considered a detailed explanation of the application to investment companies of the Internal Revenue Code (the Code), its regulations, or the various rulings issued by the Internal Revenue Service (IRS).[73] Specifically, a detailed analysis of the special tax rules applicable to the numerous investment instruments is beyond the scope of this chapter.

4.02 The subject of taxes is complex and changes constantly as a result of new legislation, regulations, rulings by the IRS, and court decisions. The auditor should be aware of such developments subsequent to the publication of this guide and should apply the information in this chapter in that context.

4.03 Investment companies are subject to federal income taxes and certain state and local taxes, as are other domestic business entities. However, investment companies registered under the 1940 Act may qualify for special federal income tax treatment as regulated investment companies under the Code and deduct dividends paid to shareholders. If a fund fails to qualify as a regulated investment company, it will be taxed as a regular corporation, and the deduction for dividends paid by the fund is disallowed. The ramifications of failure to qualify may extend even beyond the income tax consequences, because net asset values may have been improperly stated throughout the year.

4.04 This chapter discusses in general terms the requirements of the Code for qualification as a regulated investment company, the tax effects of such status, the excise tax on certain undistributed taxable income, and certain other federal income tax matters affecting investment companies under part 1 of subchapter M of the Code.[74] (Though many states have adopted provisions similar to subchapter M, a discussion of state and local taxes and tax aspects of offshore funds is beyond the scope of this chapter.) In designing the detailed audit program, the auditor should refer to the latest Code, its regulations, rulings by the IRS, and applicable state laws to be certain that all requirements for qualification have been covered and to determine the need for accruing income or excise taxes.

4.05 Certain unit investment trusts that issue periodic payment plan certificates referred to as contractual plans are not taxable entities and therefore need not file tax returns.[75] The planholders are treated as owning a proportionate share of the assets in the trust.

Requirements for Regulated Investment Companies

4.06 The Code has specific requirements for qualification as a regulated investment company.

Effect of Qualification

4.07 Qualification as a regulated investment company permits the investment company to pass investment income and capital gains to its shareholders without the investment company's incurring federal income taxes on the

[73] The tax considerations discussed in this chapter are as amended by1986 (TRA '86), which was enacted on October 22, 1986. At the time of this guide's publication, Treasury regulations had not been issued under this act.

[74] Subchapter M consists of sections 851 to 855 of the Internal Revenue Code.

[75] Section 851(f) of the Code.

amount distributed. A dividend from investment company taxable income may qualify in whole or in part for the dividend-received deduction by corporate taxpayers.[76] In computing the amount qualifying for the dividend-received deduction for corporate taxpayers, the dividend may be subject to a reduction if the qualifying dividends received are less than 100 percent of the investment company's modified gross income (see Appendix C, part II). For equity securities acquired after March 1, 1986, a dividend does not qualify for the dividend-received deduction if the holding period is less than forty-five days, regardless of whether the equity securities have been sold or disposed of otherwise. All the holding period suspension provisions relating to diminution of risk or loss apply in determining the forty-five-day period.

Requirements for Qualification

4.08 To qualify [77] as a regulated investment company for tax purposes,[78] an investment company generally must—

a. Be a domestic corporation registered for the entire taxable year under the 1940 Act. An investment company is registered on filing its notification of registration on Form N-8A.[79]

b. Elect, if it has not previously done so, to be taxed as a regulated investment company.

c. Derive at least 90 percent of its gross income from dividends, interest, income from securities on loan, and gains (without including losses) from the sale or other disposition of securities.[80]

d. Derive less than 30 percent of its gross income from gains (without including losses) on the sale or other disposition of securities held for less than three months (short-short test).

e. Meet certain requirements concerning diversification of its total assets at the end of each quarter of the taxable year.

f. Distribute at least 90 percent of its investment company taxable income for the taxable year.[81]

g. Comply with certain requirements for notification of shareholders.

4.09 Before the Tax Reform Act of 1986, incorporated investment companies were treated as single entities for tax purposes, regardless of the number of series in those companies. Under the Tax Reform Act of 1986, the qualification rules are applied separately to each taxable entity. Single-entity treatment for a series fund can have a significant effect on meeting the qualification requirements or on offsetting capital gains of one series against losses of another for purposes of determining amounts that must be distributed.

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[76] Section 854(b)(1) of the Code.

[77] Special additional rules apply to municipal bond funds. They are discussed later in this chapter.

[78] Inquiry of the client and inspection of correspondence with the transfer agent and shareholders may be sufficient to audit some of the record-keeping and notification requirements. Compliance with other requirements may be tested by completing worksheets similar to those in Appendices B and C of this guide.

[79] Each series of a series fund will be considered a registrant for this purpose.

[80] For taxable years beginning after October 22, 1986, the term *security* has the same meaning for this purpose as in the Investment Company Act of 1940. In addition, gains from transactions in foreign currencies, options, futures, and forward contracts, as well as gains from income generated by the fund's investments in stocks or securities, qualify as allowable income for the 90-percent test.

[81] Deficiency dividends may be paid pursuant to section 860 of the Code to prevent a subsequent disqualification. However, interest and penalties may be assessed. Special rules applying to municipal bond funds are discussed later in this chapter starting at paragraph 4.65.

4.10 For taxable years beginning after October 22, 1986, series funds are required to treat each portfolio within a series fund as a separate entity for tax-reporting purposes. (Existing series funds are allowed a tax-free separation to comply with this requirement. In addition, tax attributes, such as capital loss carryovers of an existing corporate series fund, should be allocated to each portfolio when separated.)

4.11 A regulated investment company not meeting all the qualification requirements in any taxable year will be taxed for that year as an ordinary corporation. In addition, a corporation that accumulates earnings and profits in a year in which it is not taxed as a regulated investment company is required to distribute those earnings and profits if it wishes to be taxed as a regulated investment company for a subsequent year.[82]

4.12 To elect regulated investment company status, an investment company prepares its tax return and computes taxable income in accordance with subchapter M. Once elected, the company's status is unchanged as long as the company continues to qualify under the Code.

4.13 Certain items require special treatment in calculating the 90-percent-of-gross-income limitation. For example, tax-exempt interest on state or local obligations is included in gross income and is considered qualifying income. Gains from the sale of options and from executing closing transactions for amounts less than the premium received are also included as qualifying income. Other income, such as redemption fees, expense reimbursements, and lawsuit settlements, may merit special consideration and may require consultation with the IRS to determine the tax status of those income items and their effect on the 90-percent-of-gross-income limitation.

4.14 To meet the diversification requirements at the end of each quarter of the taxable year, at least 50 percent of the value of the company's total assets must be represented by cash and cash equivalents, U.S. government securities, securities of other regulated investment companies, and other securities. For that purpose, other securities do not include investments in the securities of any one issuer that represent more than 5 percent of the value of the investment company's total assets or more than 10 percent of the issuer's outstanding voting securities. The diversification requirements further prohibit an investment company from investing more than 25 percent of its total assets in the securities of any one issuer, except for the securities of the U.S. government or other regulated investment companies. The requirements also prohibit investing more than 25 percent of the company's total assets in two or more issuers controlled by the investment company that are engaged in the same (or similar) or related trade or business. For that purpose, the company controls the issuers if it has 20 percent or more of the combined voting power. The investment company should keep a record of those quarterly computations.[83]

4.15 Appendix C provides guidance in applying the diversification tests under the Code.[84] The IRS has concluded that the issuer of an option or futures contract is the corporation or government that issued the underlying security, except in the case of index instruments (options and futures and options on futures based on stock indices).[85] The IRS has stated that an instrument based on a broad-based index (such as the Standard & Poor's 500 Stock Index) is regarded as a self-issued security for which the percentage tests

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[82] Section 852(a)(2) of the Code.
[83] Section 851(b)(4) of the Code.
[84] Appendix D serves the same purpose for applying similar tests for a diversified management investment company under the 1940 Act.
[85] Revenue Ruling 83-69, 1983-1, CB 126.

are applied as if the contract were a separate security. However, for an option or futures contract on a narrow-based stock index (determined by the SEC, based on each case), each issuer included in the index is regarded as the issuer of a portion of the option or futures contract. The allocation may be based on per share prices or on the market-weighting method, which is based on relative capitalization of each security in the index. Amounts so determined should be added to those for other holdings of the same security. Futures contracts on GNMAs are considered to be government securities and therefore are exempt from the diversification requirements. Futures contracts on domestic and Eurodollar certificates of deposit are considered to be self-issued.[86]

4.16 For purposes of the diversification tests, index instruments should be valued under guidelines established by the IRS, as follows: [87]

a. For futures contracts, the amount of the investment is the value of the contract, not the amount paid on margin, because the holder's liability is virtually unlimited and is related to the value of the futures contract.

b. For index options, the amount depends on whether the investment company is the writer or the purchaser of the options. A purchaser acquires a right of exercise; a writer assumes an obligation to honor a purchaser's exercise.
   - If the investment company is the writer, its potential loss is also unlimited, so the amount of the investment is the value of the security on which the option was written.
   - If the investment company is the purchaser, its potential loss is limited to the premium paid for the option, and the amount of the investment is the value of the option, not the value of the underlying security.

In certain hedging and risk-covered situations (for example, issue of a covered-call option), the securities need be counted only once for purposes of the diversification test. Similar rules may apply for valuing options and futures on debt securities.

4.17 A regulated investment company that meets the investment diversification requirements at the end of one taxable quarter does not lose its status if it fails to satisfy those requirements in a later taxable quarter, provided the noncompliance is due neither in whole nor in part to the acquisition of a security or other property. If, as a result of an acquisition, an investment company fails to meet the diversification requirements, it may reestablish its status as of the beginning of the quarter by complying with the requirements within thirty days after the end of the quarter.[88] In reviewing compliance with the diversification requirements, the auditor should become familiar with the rules set forth in the Code and regulations and should be aware that they are complicated.

4.18 A venture capital investment company (an investment company that provides capital to corporations chiefly engaged in developing new products) is exempt from meeting certain of the requirements for diversification of assets. To qualify for that exemption, the SEC must certify, not earlier than sixty days before the end of the taxable year, that the company is principally engaged in providing capital to corporations whose principal

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[86] IRS-General Counsel's Memorandum 39447.

[87] The discussion of liability and potential loss assumes that the company holds no positions or interests that could be regarded as offsetting the exposure.

[88] Section 851(d) of the Code.

business is developing or exploiting inventions, technological improvements, new processes, or products previously not generally available. If SEC certification is obtained, the 10-percent-of-voting-power test is waived and the 5-percent-of-total-asset-value test is modified in determining compliance with the requirement for 50 percent diversification of investments.

4.19 Sufficient records are also required to show that the company has complied with the investment diversification requirements during the taxable year.

4.20 A regulated investment company may elect, by filing Form 2438 within thirty days after the end of the fiscal year, to retain all or part of the net long-term capital gains realized by it during the taxable year (designated capital gain), and to pay federal income taxes on the gain on behalf of persons who were its shareholders on the last day of its taxable year (deemed distribution). As a practical matter, that decision must be made before year-end to meet accounting requirements, such as the net asset value computation, for recognizing the tax liability at year-end. Shareholders are required to report in their income tax returns their proportionate shares of undistributed long-term capital gains designated by the investment company. Shareholders may claim credit on their federal income tax returns for taxes paid on their behalf. The shareholders' tax basis is increased by the difference between the amount of undistributed long-term capital gains included in the shareholders' tax returns and the applicable amounts of capital gains taxes taken as a credit.

4.21 In addition to filing Form 2438, an investment company that makes that election must, within sixty days after the end of the fiscal year, send Form 2439 to each person who is a shareholder of record at the close of the year, stating the amount of long-term capital gains to be included by the shareholder in the return and the tax paid by the investment company on that amount. If Form 2439 is sent to a shareholder of record who is a nominee of the actual owner, the nominee is required to provide the actual owner with a separate Form 2439.[89]

4.22 Short-term losses incurred by a shareholder on the sale or exchange of shares in a regulated investment company are recharacterized as long-term losses to the extent of capital gains dividends or designated capital gains on such shares.[90]

4.23 For purposes of the qualification tests, a regulated investment company may designate as applicable to the prior taxable year all or part of any dividends, including capital gains distributions, declared after the end of its taxable year. Such dividends or distributions must be declared before the due date for filing the corporate return, including any extensions. The dividends or distributions must be paid within twelve months after the end of the taxable year and not later than the date of the first regular dividend payment after such declarations.[91]

4.24 If a computation of taxable income after the end of the taxable year, which results from an IRS determination, causes an increase in investment company taxable income, an increase in the excess of net capital gain over the deduction for capital gain dividends paid, or a decrease in the deduction for dividends paid (without regard to capital gain dividends), a regulated investment company may pay deficiency dividends to protect its special tax status or to avoid payment of tax. Interest and penalties, however, may be assessed.[92]

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[89] Section 852(b)(3)(D) of the Code.
[90] Section 852(b)(4)(A) of the Code.
[91] Section 855 of the Code.
[92] Section 860 of the Code.

4.25 If a regulated investment company does not distribute all its investment company taxable income, even though it meets the 90-percent test, it must pay corporate income taxes on the undistributed portion. Similarly, if the company fails to distribute its net realized capital gains, the company is subject to the same taxes on the gains as an ordinary corporation.

4.26 Although a regulated investment company (RIC) may elect a calendar or fiscal year-end, substantially all its calendar-year income must be distributed to shareholders during the calendar year, effective for calendar years beginning after December 31, 1986. Required distributions in excess of the amount distributed during the calendar year are subject to a nondeductible excise tax of 4 percent. The excise tax is payable on or before March 15 of the following year.

4.27 To determine the excise tax, an RIC's income is categorized as ordinary income or capital gain net income. Ordinary income is all income reported by the RIC during the calendar year other than gains or losses from sales of capital assets. Capital gain net income is the net of short- and long-term gains and losses from sales or exchanges of capital assets. Capital gain net income is determined by treating the one-year period ending October 31 as if it were the RIC's taxable year. If an RIC has a fiscal year ending in November or December, it may irrevocably elect to determine its capital gain net income as of the end of that fiscal year.

4.28 To avoid the excise tax, an RIC must distribute at least 97 percent of its calendar-year ordinary income, 90 percent of its capital gain net income, and 100 percent of ordinary capital gain net income from the prior year, which was not previously distributed.

4.29 To compute the excise tax, the amount distributed during the calendar year includes dividends paid during the calendar year, charges to earnings and profits resulting from redemptions (equalization debits), undistributed investment company taxable income taxed at the RIC level, retained net capital gains taxed at the RIC level, and excess distributions from the previous year. Dividends declared in December to shareholders of record as of a specified date in December and actually paid before the following February 1 are treated as a dividend paid by the fund during the preceding calendar year. The shareholder also treats the deemed December dividend as if it were received on the record date.

4.30 The excise tax on calendar-year income is a separate tax. Hence, the distribution requirements for the excise tax are independent of the RIC qualification requirements of section 852. Investment company taxable income should, therefore, be computed based both on a fiscal year and a calendar year. Adjustments for book/tax differences—for example, dividends received—should be calculated for both the calendar and fiscal years.

4.31 An open-end investment company may, as discussed in chapter 1, use equalization accounting. Equalization debits have often been treated as dividends paid in applying the 90-percent-distribution test and in determining accumulated earnings and profits.[93] That treatment was first codified under the Tax Reform Act of 1984, which provides that earnings and profits should be reduced by redemptions of the corporation's stock in proportion to the amount of the corporation's outstanding stock. Equalization credits have not been treated as taxable income.

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[93] Revenue Ruling 55-416. A National Office technical advice memorandum ruled that netting of credits and debits would not be proper.

4.32 Shareholders are taxed in the years in which dividends or distributions are paid to them. However, for calendar years after 1986, dividends declared in December, payable to shareholders of record on a date in December and paid before the following February 1, are treated as paid by the investment company and received by the shareholders on the December record date. A regulated investment company must notify its shareholders (calendar-year companies often use Form 1099 for this purpose) within sixty days after the end of its taxable year of amounts distributed during its taxable year, or otherwise reportable to a shareholder, that represent capital gains dividends, qualifying dividends, foreign tax credits, interest dividends, and exempt interest dividends subject to the alternative minimum tax.[94] The company must also notify shareholders (on Form 2439) of long-term gains retained and taxes paid on behalf of shareholders.

4.33 The Tax Reform Act of 1986 (TRA '86) allows individuals to itemize miscellaneous deductions to the extent that they exceed a floor (2 percent of adjusted gross income for 1987). TRA '86 provides that, pursuant to Treasury regulations, the floor applies to indirect deductions through pass-through entities (including regulated investment companies). At the publication date of this guide, no regulations had been issued on the nature or reporting of those items. Presumably, reporting of pass-through items by an investment company would have no effect on determining the amount of income required to be distributed. Such items would have an effect on the shareholders' tax position.

4.34 An investment company taxed as a regulated investment company is prohibited from claiming a net operating loss deduction. Occasionally, an investment company, especially a new one, may incur a net operating loss that it cannot use if it elects to be a regulated investment company in succeeding years. In such circumstances, the company may delay its election to be taxed as a regulated investment company so it can realize the benefit of the carryover loss.

4.35 A net capital loss may be carried forward by a regulated investment company to eight succeeding taxable years, but it may not be carried back to any preceding year in which the company qualified as a regulated investment company.[95]

4.36 If an investment company has an available capital loss carryover, but attempts to distribute to shareholders net capital gains realized in the current year, the entire distribution or a portion of that distribution equal to the amount of the unused carryover may be taxable to shareholders as ordinary income. Distributions are taxable as ordinary income to the extent of current or accumulated earnings and profits, as defined for federal income tax purposes.

4.37 The Tax Reform Act of 1984 permits a personal holding company to elect regulated investment company status if it was taxed as a regulated investment company for all taxable years after November 8, 1983, or as of the end of the taxable year has no earnings and profits from a year in which the corporation was not a regulated investment company.[96] However, the undistributed taxable income of a regulated investment company that is a personal holding company is subject to taxation at the highest corporate rate.[97]

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[94] Sections 852(b)(3)(C), 854(b)(2), and 852(b)(5)(A), respectively, of the Code.

[95] Section 1212(a) of the Code.

[96] Section 852(a)(3) of the Code.

[97] Section 852(b) of the Code.

Other Income Tax Considerations

Dividends and Interest

4.38 Investment companies record dividend income on the ex-dividend date for accounting purposes. However, for tax purposes, such income should be reported when it is actually or constructively received.[98]

4.39 If a dividend or other distribution received by the company represents a return of capital, the basis of the security is reduced for tax purposes. The accounting treatment for such distributions can differ from that required for income tax purposes.

Sales of Securities

4.40 The cost of securities sold or otherwise disposed of may be either specifically identified or determined on a first-in, first-out (FIFO) basis; the average-cost basis is unacceptable for tax purposes. Proof of delivery of certificates representing securities from a lot purchased or acquired on a certain date for a certain price is one acceptable means of specific identification. If the securities are in the custody of a broker, a custodian bank, or other agent, an acceptable method of specific identification is to instruct the agent to sell a particular block of securities (identified by date of purchase, name of broker from whom purchased, and unit price). Written confirmation of these specifications must be received from the agent within a reasonable time after the instructions have been transmitted.[99] The agent can deliver securities from any lot regardless of the specifications without preventing the company from treating the securities by specific identification for tax purposes.

4.41 A wash sale occurs on a sale of securities if the seller acquires or enters into a contract or option to acquire substantially identical securities within a period beginning thirty days before the date of sale and ending thirty days after such date (a sixty-one day period). A loss resulting from such a transaction is not deductible for tax purposes; the amount of the loss increases the tax basis of the new security purchased, and the holding period of the new position includes the holding period of the original position. However, a gain on the same type of transaction is taxable, and the tax basis of the new security is not affected by the sale of the old security.

4.42 In a short sale, the seller's broker lends or arranges for securities or other property to be lent to the seller for delivery at the time of the short sale. (The seller may or may not own equivalent securities at that time.) For tax purposes, a short sale is not deemed to be consummated until equivalent securities are delivered by the seller to the lender, closing the short sale. The gain or loss on a security used to close a short sale is always short term. If the investment company owns equivalent shares at the time of the short sale, but additional shares are bought to cover the short sale, the holding period of a regulated investment company's remaining position may also be shortened.

Commissions

4.43 Commissions related to purchases or sales of securities are not deductible but are added to the cost of the securities or offset against the selling prices.

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[98] Regulation 1.301-1(b) of the Code.

[99] Regulation 1.1012-1(c)(3) of the Code.

Bond Discount and Premium

4.44 The rules for determining the tax treatment of original issue discount (OID), market discount, and premium on bonds purchased have changed substantially in recent years as the result of legislation. The method of computing amortization, if required, depends on the type of obligation, the date issued, and the date acquired. The tables in appendix B should be consulted for an overview of the general tax provisions for discount on debt obligations purchased.

4.45 Acquisition discount (which includes original issue and market discount) on short-term obligations (less than one year from date of issue) of the U.S. government, such as Treasury bills, and on obligations of other government bodies having the full faith and credit of the U.S. government, acquired after July 18, 1984, must be accrued ratably as interest income. An irrevocable election can be made for any obligations to accrue acquisition discount using the constant interest (yield to maturity) method in place of the ratable calculation. Previously, such discounts were not taxable until the obligations were paid at maturity or sold, regardless of the method of accounting used by the company.[100] Gains in excess of the ratable share of such acquisition discounts are treated as capital gains; losses are similarly treated as capital losses.[101]

4.46 For long-term obligations, an OID is the difference between the issue price and the stated redemption price at maturity. An OID that is less than 0.25 percent of the redemption price at maturity multiplied by the number of complete years to maturity is considered not to be an OID for tax purposes.[102]

4.47 For obligations issued after July 18, 1984, a gain on the disposition of long-term market discount bonds (having a maturity of more than one year) is taxed as ordinary income to the extent of any accrued market discount. Market discount is defined as the excess of the stated redemption price of a bond over the adjusted basis immediately after its acquisition by the taxpayer. For OID bonds that were acquired at a market discount, the stated redemption price is treated as equal to its revised issue price—that is, the sum of the original issue price of the bond and the aggregate amount of OID includable in the gross income of all holders for periods before the bond was acquired by the taxpayer. Market discount is considered to be zero if the market discount is less than 0.25 percent of the stated redemption price at maturity multiplied by the number of complete years to maturity after the taxpayer acquired the bond.[103]

4.48 A market discount bond is defined as any bond having a market discount, except for bonds with fixed maturities not exceeding one year from the date of issue, bonds with tax-exempt interest, U.S. savings bonds, and installment obligations.

4.49 Accrued market discount is computed by determining the amount that bears the same ratio to the market discount on the bond as the number of days that the taxpayer held the bond bears to the number of days after the date the taxpayer acquired the bond, up to (and including) the date of maturity. Thus, market discount is treated as though it were accruing in equal daily installments during the period the bond is held by the taxpayer. However, the taxpayer may elect to compute market discount using the constant-

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[100] A regulated investment company may elect to accrue a discount ratably for all years ending after December 31, 1978.

[101] Sections 1271 and 1281 of the Code.

[102] Section 1273(a) of the Code.

[103] Section 1278(a)(2)(C) of the Code.

interest (yield to maturity) method. In any event, the taxpayer can report amortization of market discount on a daily basis or at disposition. (See appendix B.)

4.50 For obligations issued before July 19, 1984, a discount other than OID may not be amortized and is reported as a gain or loss on disposition. Special rules apply to leveraged bonds issued before July 19, 1984, and acquired on or after that date.

4.51 For tax purposes, amortization of bond premium on fully tax-exempt and partially tax-exempt bonds is mandatory. Amortization of premiums on fully taxable bonds is subject to an election, which is binding for all future acquisitions of fully taxable bonds. [104] If amortization is elected, a premium on bonds issued after September 27, 1985, should be amortized using the constant-interest method.

4.52 Interest received on bonds that trade flat is a return of capital, rather than taxable income, to the extent that it relates to the period before the purchase.

Straddles

4.53 Generally, a straddle consists of offsetting positions in personal property and thus results in a substantial diminution of risk from holding those positions. [105] If a straddle is deemed to exist, the positions are subject to extensive rules for straddles. [106] Generally, the rules for straddles require the deferral of realized losses to the extent of unrealized gains on the offsetting positions in the straddle. Losses in excess of unrelated gains, if any, may be recognized in the year the losses occur. The rules for straddles are complex and contain detailed rules on the tax treatment for the security position hedged and the offsetting position—for example, a non-equity option or futures contract. A detailed discussion of those rules is beyond the scope of this chapter.

Equity Options

4.54 Equity options include puts and calls on individual stocks or on narrow-based stock indices, such as those pertaining to particular industry segments. For book purposes, purchases of puts and calls are recorded at cost and are marked to market each day. If exercised, the sales proceeds (put) are reduced by the cost of the option or the basis of the security acquired (call) is increased. If an option expires worthless, the entire cost of the option is a capital loss. If an option is closed through a closing sale, the difference between the amount paid and the amount received is a capital gain or loss. A purchase of a put option may result in a change in the beginning of the holding period of securities underlying the option to the date when the put option expires or is exercised. [107]

4.55 A sale of a call option is subject to special rules to determine whether the option is a qualified covered call option (QCCO). [108] If the option is a QCCO, the stock and the option are not subject to the straddle rules. [109] Otherwise, the stock and the option are presumed to be positions in a straddle. There are also special rules for QCCOs that are in-the-money when written. In

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[104] Section 171(c) of the Code.
[105] Section 1092(c) of the Code.
[106] Section 1092 and regulation sections 1.1092(b)-1T through 1.1092(b)-5T of the Code.
[107] Section 1233(b) and (c) of the Code.
[108] Section 1092(c)(4)(B) of the Code.
[109] Section 1092(c)(4)(A) of the Code.

addition, there are special rules for QCCOs closed within thirty days of sale of the security if the transaction occurs in different years.[110]

4.56 Subject to the rules in straddles discussed above, premiums received on put and call equity options sold are recorded as deferred income until the option expires, is exercised, or is closed by an offsetting purchase. At expiration, the premium received is recorded as a capital gain. At exercise, the premium is added to the proceeds of the security sold (call) or subtracted from the cost of the security purchased (put). If closed by an offsetting purchase, the difference between the premium received and the premium paid for the offsetting option is a short-term capital gain or loss.

Non-Equity Options and Futures

4.57 All non-equity options (such as options on broad-based stock indices, bonds, and futures) and futures contracts generally are subject to special mark-to-market and 60 percent long-term/40 percent short-term rules, under which all positions are considered closed out at their fair market values at the end of the tax year.[111] The resulting gain or loss is characterized as a 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. For purposes of the excise tax, October 31 is considered an additional year-end. The basis of the position is adjusted for gain or loss realized by operation of the mark-to-market rule. Similarly, realized gains or losses related to such positions are characterized as 60 percent long-term and 40 percent short-term. However, for purposes of the test requiring that less than 30 percent of a fund's gross income be derived from sales of securities held less than three months, the entire amount of the gain is included in the numerator (and denominator) of the fraction if the non-equity option or futures position was held less than three months. (Special rules apply for designated hedge transactions. See the discussion below.) The IRS has held privately, however, that gains on futures positions outstanding for less than three months at the end of a fiscal year, which are deemed to be closed at their fair market value at that time, are considered to be gains on securities held for three months or more. If a non-equity option or future hedges a security held in a fund's portfolio, it is necessary to determine whether the positions constitute a straddle.

4.58 The Tax Reform Act of 1986 provides for netting of increases and decreases in the value of positions that are part of a designated hedge during the period of the hedge for purposes of the short-short rule of section 851(b)(3). That rule is based on the theory that for hedging transactions, both the hedged and the hedging positions are properly considered to be a single investment. The netting rule applies both in determining the RIC's short-short gain and in computing the RIC's gross income for the numerator and denominator of the short-short test.

4.59 A designated hedge is defined to include situations in which the RIC's risk of loss is reduced because (*a*) the RIC has an option to sell, is under a contractual obligation to sell, or has made and not closed a short sale of substantially identical property; (*b*) the RIC is the grantor of an option to buy substantially identical property; or (*c*) under Treasury regulations, the RIC holds one or more other positions. For those purposes, a qualified cover call, as defined in Code section 1092(c), should be treated as part of a designated hedge.

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[110] Section 1092(f) and (c)(4)(E) of the Code.

[111] Section 1256(b) of the Code.

4.60 Treasury regulations will specify the manner in which a hedge should be designated. Until issuance of such regulations, a designated hedge should be identified at the close of the day in which the hedge is established by either placing the hedge positions in a hedging account maintained by a broker or custodian, or by designation by a broker or custodian of those positions as hedges for purposes of this hedging exception. The RIC must receive a written confirmation that states the date the hedge is established and that identifies the hedged and hedging positions.

4.61 The tax treatment of non-equity options or futures and the related securities positions may have a significant effect on the amount of capital gain or loss that a fund has available for distribution. In certain cases, taxable gain is recognized even though the position has not been liquidated. Therefore, a fund may not have cash equal to the tax-basis capital gains that it must distribute. In addition, the deemed recognition of gain (or loss) under certain rules and the related holding period adjustments should be carefully considered in monitoring compliance with the restriction that less than 30 percent of a fund's gross income be derived from sales of securities held less than three months.

Stock Issuance Costs

4.62 Stock issuance costs paid by the company are deductible for tax purposes except for costs incurred during the initial stock-offering period.[112] Costs incurred in the merger of investment companies are not deductible.[113] Registration fees and expenses, including accounting procedures, are discussed in further detail in chapter 8.

Stock Redemption Costs

4.63 Stock redemption costs of open-end regulated investment companies are deductible in computing investment company taxable income. Stock redemption costs of closed-end investment companies paid or incurred after February 28, 1986, are not deductible.

Foreign Tax Credit

4.64 A regulated investment company may elect to pass foreign tax credits to its shareholders if more than 50 percent of the value of its total assets at the end of the taxable year consists of securities in foreign corporations, and if it has complied with certain IRS and shareholder notice requirements.[114] If less than 50 percent of total asset value consists of such securities, the credit may not be passed through but is available to the fund as a deduction from taxable income or as a foreign tax credit.

Municipal Bond Funds

4.65 A municipal bond fund taxable as a corporation must qualify as a regulated investment company before it can pay tax-free dividends to shareholders.[115] A municipal bond fund usually realizes a relatively small amount of taxable income. In addition to the requirements discussed in paragraph 4.08, the fund also must distribute at least 90 percent of its total taxable and net

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[112] Revenue Ruling 72-13.

[113] Regulation 1.248-1 of the Code.

[114] Section 853 of the Code.

[115] Tax-exempt unit investment trusts generally are not organized as associations taxable as corporations for federal income tax purposes. Interest earned by those trusts is exempt from federal income tax and retains that status when distributed by such trusts to unit holders.

tax-exempt income.[116] Such funds are also subject to the excise tax on undistributed taxable ordinary income and capital gains.

4.66 A regulated investment company that meets certain requirements in addition to those already mentioned may pass tax-exempt interest through to its shareholders as exempt-interest dividends.[117] As a result of the Tax Reform Act of 1986, tax-exempt interest from private activity bonds issued after August 7, 1986, is considered a tax-preference item for the alternative minimum tax for an individual shareholder's taxable year beginning after December 31, 1986. All other exempt-interest dividends are includable in calculating the book/tax-preference item in computing the alternative minimum tax for corporations. A dividend qualifies as an exempt-interest dividend only if both of the following conditions are met:

a. At least 50 percent of the value of the total assets of the regulated investment company at the close of each quarter of its taxable year consists of certain tax-exempt government obligations.

b. The dividend is designated by the regulated investment company as an exempt-interest dividend in a written notice mailed to shareholders not later than sixty days after the end of its taxable year.[118]

4.67 If a fund is disqualified from treating distributions as exempt-interest dividends, it may still qualify as a regulated investment company if it meets the other applicable tests. However, its distributions are fully taxable.

4.68 Because premiums paid on purchases of obligations of states, territories, and possessions of the United States, or their political subdivisions, must be amortized for federal income tax purposes, most funds have also chosen to amortize them for book purposes. For amortization of the premium on a callable tax-exempt bond, Treasury regulations state that the earlier call date will generally be considered to be the maturity date.[119] The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at that date, or the earliest date at which the bond is callable at par; or another call date before maturity specified in the bond may be selected by the taxpayer. However, the IRS has ruled that to determine the amortization of a premium on a tax-exempt security, the following must be true:

a. The bond premium in excess of the call price, if any, must be amortized to the earliest call date and the basis of the bond reduced accordingly.

b. A remaining excess premium over a subsequent call price must be amortized to a subsequent call date. (At any given point, the remaining excess premium is the total premium, that is, the amount paid in excess of maturity value, reduced by previous amortizations to previous call dates.)

c. The portion of the premium equal to the difference between the last call price and the maturity value is amortized over the period from the last call date to maturity.[120]

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[116] Section 852(a) of the Code.

[117] A loss incurred by a shareholder within six months of the date of purchase of shares in a tax-exempt mutual fund is disallowed to the extent of the amount of a tax-exempt interest dividend received, if any. The six-month period may be shortened by regulations.

[118] Section 852(b)(5)(A) of the Code.

[119] Regulation 1.171-2(b)(1) under the Code.

[120] Revenue Ruling 60-17.

4.69 For obligations issued before September 28, 1985, a fund may amortize bond premiums using any reasonable method regularly employed. If the method used does not comply with the "reasonable method" requirement, amortization must be on a straight-line method. TRA '86 requires premium amortization on obligations issued after September 27, 1985, to be computed under a constant-interest method.

4.70 An original issue discount on tax-free bonds is generally amortized for book and tax purposes. (OID on tax-exempt obligations maturing over one year from the date of issue must be accrued on a yield-to-maturity or straight-line method, depending on the date of issue. For short-term tax-exempt obligations, OID must be accrued ratably, unless a yield-to-maturity method is elected. See appendix B.)

4.71 The Code requires a municipal bond fund's allowable deductions to be allocated between its taxable and tax-exempt income. (Capital gains are excluded from this calculation.) The only acceptable basis of allocation appears to be the ratio of tax-exempt income to gross investment income (tax-exempt plus taxable). The required amortization of premium on tax-exempt bonds must be allocated to the tax-exempt income.

4.72 Net gains realized by municipal bond funds on the sale of investments are taxable, though their investment policies may require that 100 percent of their assets be invested in tax-exempt securities; this results in tax-exempt interest.

4.73 A municipal bond fund's distribution policies should consider the tax effects on its shareholders in addition to following the requirements prescribed by the Code. Because gains realized on redemption of capital shares are taxable to the shareholders, dividends from net investment income frequently are declared daily to maximize the amount received by shareholders as tax-exempt income. Dividends usually are paid monthly, but shareholders may receive accrued dividends at the time of redemption.

4.74 Funds that do not declare dividends daily may use equalization accounting as described in chapter 1. A municipal bond fund that realizes a significant amount of taxable income, usually interest on investments in short-term securities, should allocate equalization debits and credits between undistributed tax-exempt income and taxable income.

4.75 In defining earnings and profits of a regulated investment company, section 852(c) of the Code and Treasury Regulation 1.852-5(b) state that "earnings and profits . . . for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for such taxable year." That may cause a distribution of income equalization credits to be taxed as ordinary income, as illustrated here.

	Book Undistributed Income	*Tax-Basis Earnings and Profits*	
		Current	*Accumulated*
Tax-exempt interest income	$100,000	$100,000	$100,000
Expenses	(16,000) *	—	(16,000)
Income equalization credits (net)	12,000	—	—
Balance	96,000	100,000	84,000
Dividends paid +			
Exempt interest dividends	84,000 ‡	84,000	84,000
Ordinary dividends	12,000 §	12,000	—
Total dividends	96,000	96,000	84,000
Undistributed income at year-end	$ 0 #	$ 4,000	$ 0

* Not deductible from current earnings and profits (Treasury Regulation 1.852-5(b)).
\+ Based on the assumption that the fund's policy is to distribute all of its net equalization credits.
‡ Exempt-interest dividends = $84,000 ($100,000 – $16,000).
§ Distribution in excess of exempt-interest dividend may be taxed as ordinary income (Treasury Regulation 1.852-5(b)).
\# Based on the assumption of a dividend payment on the last day of each month. The undistributed balance of current earnings and profits has no federal income tax significance, because the fund has distributed its net tax-exempt income (section 852 of the Code).

Tax-managed Funds

4.76 In an attempt to accumulate investment income and realized gains with little or no tax consequences, tax-managed funds do not pay dividends and minimize or eliminate corporate income taxes by various management techniques. Because such funds are taxed as regular corporations and not as regulated investment companies, they should accrue currently payable and deferred income taxes based on generally accepted accounting principles. The need to accrue accumulated earnings tax should be considered. Since enactment of the Tax Reform Act of 1984, those funds have become less popular.

Small Business Investment Companies

4.77 A small business investment company (SBIC) operating under the Small Business Investment Act of 1958 (the 1958 Act) receives special tax treatment. It is allowed certain exclusions or additional deductions without the limitations prescribed for other corporations.

4.78 An SBIC operating under the 1958 Act is allowed a 100 percent deduction for dividends received from a taxable domestic corporation unless the SBIC elects to be taxed as a regulated investment company.[121] To claim that deduction, the company must file with its return a statement that it was a federal licensee under the 1958 Act at the time the dividends were received.

4.79 If stock issued by a small business investment company is sold, exchanged, or becomes worthless, an ordinary loss, instead of a capital loss, can be recognized pursuant to the conversion privilege of convertible debentures.[122] Capital losses on other investments receive no special treatment. The company must submit with its tax return a statement that it is a federal licensee under the 1958 Act and also must report the following:

[121] Section 243(a)(2) of the Code.
[122] Section 1243 of the Code.

a. The name and address of the small business concern on whose securities the loss was sustained

b. The number of shares of stock

c. The basis and selling price

d. The dates the securities were bought and sold or the approximate date on which they became worthless and the reason [123]

4.80 There are special provisions for reserves for losses (for example, statutory bad-debt deductions) on loans of SBICs.[124] An SBIC may obtain special treatment for net operating losses and may be excluded from the definition of a personal holding company.[125]

4.81 A shareholder in a small business investment company may treat a loss on its stock as an ordinary loss. In computing the net operating loss deduction, such a loss is treated as a loss from a trade or business.[126]

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[123] Regulation 1.1243-1(b) of the Code.
[124] Section 586 of the Code.
[125] Sections 172(b)(1)(F) and 542(c)(8) of the Code.
[126] Section 1242 of the Code.

Chapter 5

Financial Statements of Management Investment Companies

5.01 The overall objectives of financial statements of management investment companies are primarily to present net assets, results of operations, and changes in net assets resulting from investment activities and, if applicable, from capital share transactions. In reporting to shareholders, the SEC requires presentation of the following financial statements and supplementary information:

a. A statement of assets and liabilities or a statement of net assets, which includes a detailed list of investments in securities, covered call options written, securities sold short, and other investments as of the close of the latest period

b. A statement of operations for the latest period

c. A statement of changes in net assets for the latest two years

d. Selected per share data and ratios for the latest five years[127]

5.02 A two-year statement of changes in net assets is required because a presentation of that statement with per share data and ratios and related information provides the user of the financial statements with sufficient financial information to do the following:

a. Account for changes in the statement of assets and liabilities resulting from investment activities and capital share or other transactions.

b. Summarize amounts in the statement of operations for net investment income, realized gains or losses from security transactions, and changes in unrealized appreciation or depreciation of investments.

c. Compare dividends paid to shareholders with related income.

5.03 The financial statements illustrated in this chapter are for typical open-end management investment companies and may need to be modified to fit the requirements of other types of investment companies. Aspects of reporting on interim financial information are discussed in this chapter in the section on interim financial statements.

5.04 The management of an investment company and its auditors should recognize the need to prepare the financial reports in a manner that highlights significant information to shareholders and other interested parties and, if applicable, that fulfills the requirements of the reporting forms, rules, and regulations of a regulatory authority.

Reporting Financial Position

5.05 Investment companies report financial position by presenting either a statement of assets and liabilities or a statement of net assets; the choice depends on which format more clearly portrays the information. Regulation S-X provides that a statement of net assets should not be presented if the amount of investments in securities of unaffiliated issuers represents less than 95 percent of total assets.

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[127] Item 3(a) of Form N-1A requires condensed financial information, share data and ratios, to be presented for the latest ten years in the fund's prospectus. The most recent five-year period should be covered by the auditor's report.

5.06 The statement of assets and liabilities presents a list of the assets, a list of the liabilities, and an amount for net assets equal to the difference between the totals. Because a list of individual securities is not presented in the body of the statement, a separate schedule of investments in securities is required. The statement of assets and liabilities is particularly appropriate for investment companies that have significant assets other than investments in securities, or that have significant liabilities.

5.07 The statement of net assets presents a detailed list of portfolio securities and a net amount for all other assets and liabilities. Details of other assets and liabilities should be presented in the statement or in the notes if the amounts are material to total assets or total liabilities.

Assets

5.08 Following are the major asset categories reported in a statement of assets and liabilities.

Investments in Securities

5.09 The general practice in the investment company industry is to report investments in securities as the first asset because of their relative importance to total assets. The term *securities* includes stocks, bonds, debentures, notes, rights, warrants, certificates of interest or participation in equity or debt instruments, and the like, as well as short-term U.S. government securities, bank certificates of deposit, bankers' acceptances, and commercial paper.

5.10 Investment companies should report their securities in financial statements at value, with acquisition cost shown parenthetically for major classifications of securities, as discussed in chapter 2. Investments in foreign securities should also be reported at value by converting their foreign currency denominated value into U.S. dollars using current exchange rates. Net realized gains and losses and changes in unrealized exchange gains and losses should be included with net realized gains and losses and changes in unrealized gains and losses on investments. Individual securities held by the fund at the close of the period should be listed in the statement of net assets or in an accompanying list by the major classifications of the investments in the portfolio if a statement of assets and liabilities is used.[128] Investments in foreign securities, if significant, should be disclosed and presented separately in a representative grouping. Securities should be arranged in the most meaningful manner within each classification by industry or other grouping, showing the percentage of assets in each group.

5.11 The portfolio of investments should list the number of shares or the principal amount and value of each security issue. Because a detailed list of short-term investments is not normally significant to the user or material to issuers other than money market mutual funds, such investments may be summarized by issuers disclosing their ranges of interest rates and maturity dates. Investments in restricted securities, affiliated companies, securities subject to call options, and the like require special identification in the list of investments and may require disclosure of specific information in the notes to the financial statements.[129] Investment accounts are discussed in detail in chapter 2.

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[128] Rules 6.04, 6.05, 6.10, and 12.12 of Regulation S-X apply to registered investment companies.

[129] For specific requirements concerning disclosures of information relating to restricted securities and affiliated companies, see SEC, *Codification of Financial Reporting Policies*, sections 404.03-404.04.

Cash

5.12 Cash on hand and demand deposits are included under the general caption *cash*. Foreign currencies should be disclosed separately, if material. Time deposits and other funds subject to withdrawal or usage restrictions should be presented separately from other cash amounts.[130] Applicable interest rates and maturity dates should be disclosed.

Receivables

5.13 Receivables are usually listed separately for each of the following categories:[131]

a. Dividends and interest

b. Investment securities sold

c. Capital stock sold

d. Other accounts receivable, such as receivables from related parties or expense reimbursements from affiliates

Other Assets

5.14 Deferred organization expense, prepaid taxes, furniture and fixtures, and so on normally are included under this caption. Separate amounts are usually not reported unless significant.

Liabilities

5.15 The following categories of liabilities are reported in the statement of assets and liabilities.

Accounts Payable

5.16 Accounts payable usually are listed separately for investment securities purchased and capital stock reacquired.

Call or Put Options Written, Futures Contracts Sold, and Securities Sold Short

5.17 Call options written and securities sold short at the close of the period should be presented separately. Information presented for covered call options should include the number of shares subject to call for each option written, the value of each option, the strike price, and the exercise date. Details of the securities sold short, other options written, and futures contracts sold should include information about quantities, values, and proceeds.

Accrued Liabilities

5.18 Accrued liabilities include liabilities for taxes, management fees, interest, compensation, and other expenses incurred in the normal course of operations.

Notes Payable and Other Debt

5.19 Notes payable to banks and to others and other funded debt should be reported separately.

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[130] Rule 5.021 of Regulation S-X.
[131] Rule 6.04 of Regulation S-X.

Other Liabilities

5.20 Other liabilities include amounts payable to affiliates for collateral on return of securities loaned, for deferred income, and for dividends.

Net Assets

5.21 Shareholders' equity includes amounts contributed by shareholders, undistributed net investment income, accumulated undistributed net realized gains or losses, and unrealized appreciation or depreciation on investments. Though it is unnecessary to present the accounts separately in the statement of assets and liabilities, the statement or the notes should disclose information about—

a. Units of capital, including the title of each class of capital shares or other capital units, the number authorized, the number outstanding, and dollar amount.

b. Paid-in capital, which includes the net proceeds received on the sale of capital shares less the cost of reacquired shares, adjusted for amounts apportioned to the equalization account, if that accounting practice is followed.

c. Undistributed investment income, which includes cumulative net investment income or loss and amounts apportioned to the equalization account, if that accounting practice is followed, less dividends paid from net investment income (amounts at the end of the periods presented are normally disclosed in the statement of changes in net assets).

d. Accumulated net realized gains and losses, that is, cumulative amounts of gains and losses realized from securities transactions, net of actual or deemed dividends to shareholders.

e. Unrealized appreciation or depreciation of investments, representing the difference between the acquisition cost and the value of the securities owned at the close of the period. If there is a provision for deferred income taxes on unrealized appreciation, it should be charged against this account and disclosed.

5.22 Tax-managed funds (discussed in detail in chapter 4) should combine the amounts for undistributed investment income, realized gains and losses, and changes in unrealized appreciation or depreciation, because tax-managed funds normally do not qualify for treatment as regulated investment companies and are therefore treated as regular corporations.

5.23 *Net Asset Value Per Share.* Net asset value per share is the amount of net assets attributed to each share of capital stock (other than senior equity securities) outstanding at the close of the period.

Statement of Operations

5.24 The objective of the statement of operations is to present an increase or decrease in net assets resulting from all of the company's investment activities, by reporting investment income from dividends, interest, and other income less expenses, the amounts of realized gains or losses from securities transactions, and changes in unrealized appreciation or depreciation of investments for the period. That format helps the user understand the contribution of each aspect of investment activity to the company's overall operations.

Investment Income

Dividend Income

5.25 Dividend income is recorded as of the ex-dividend date. Dividends from affiliates and controlled companies are usually reported separately and disclosed in the statement or in the notes. (Chapter 2 discusses noncash dividends, dividends in arrears on preferred stocks, and dividends from other than retained earnings.)

Interest Income

5.26 Interest income generally is accrued on all debt securities. However, chapter 2 discusses special reporting requirements for interest received on bonds in default when acquired and for interest on delinquent debt securities. Interest earned on securities of affiliates and controlled companies is disclosed.

Other Income

5.27 Other income includes income from securities loaned and from miscellaneous sources. All items are usually combined except those deemed to be material.

Expenses

5.28 Though expenses, either individually or in the aggregate, are seldom material to net assets or to changes in net assets, the following expenses are commonly reported separately by the mutual fund industry:

- *a.* Investment advisory (management) fees (or compensation)
- *b.* Shareholder service costs, including fees and expenses for the transfer agent and dividend disbursing agent
- *c.* Distribution expenses (discussed in chapter 8)
- *d.* Custodian fees
- *e.* Reports to shareholders
- *f.* Federal income taxes (chapter 8 discusses the provision for taxes for companies that do not meet the requirements necessary to qualify as a regulated investment company)
- *g.* Other taxes
- *h.* Interest
- *i.* Dividends on securities sold short
- *j.* Professional fees
- *k.* Directors' fees
- *l.* Registration fees and expenses (discussed in paragraph 8.19)

To the extent practical, expenses subject to the 5 percent disclosure requirement would be those itemized in the SEC's semiannual report Form N-SAR. An investment company that is managed internally and that does not incur investment advisory fees generally would report its expenses on Form N-SAR under the caption for salaries and other compensation. Because of SEC requirements, it has become customary to present separately amounts of expenses equal to or greater than 5 percent of total expenses.

5.29 Amounts paid to affiliates or related parties should be disclosed in accordance with FASB Statement No. 57, *Related Party Disclosures.* The basis for determining management and advisory fees, as well as other amounts paid to affiliates or related parties, should be described in a note to the financial statements. If state laws or the advisory agreement provide that the adviser should reimburse the company for expenses in excess of a specified percentage of average net assets, the contract terms and the amount of reimbursement, if any, should be disclosed. (If a reimbursement occurs, the amount should be shown as a reduction of total expenses.) If an adviser voluntarily waives all or a portion of the fee, the amount waived together with the effect on per share data should be disclosed, but need not be stated separately in the statement of operations. In addition, sales and payments to affiliates under a 12b-1 distribution plan should be disclosed. The auditor should be aware of the disclosure requirements in section 30(d)(5) of the 1940 Act, which deals with aggregate remuneration to directors and to each company of which any officer or director is an affiliated person. The auditor may determine that the investment company has complied with the requirements by disclosure in the notes to the financial statements, or in some other manner that the investment company's management or legal counsel determines to be appropriate.

Investment Income—Net

5.30 The excess of investment income over total expenses should be shown as investment income—net.

Realized Gains or Losses on Investments

5.31 The statement of operations should disclose net realized gains or losses, if significant, by major types of securities transactions, such as long transactions, short sale transactions, and covered call option transactions. Net realized gains or losses resulting from sales or other disposals should be reported net of brokerage commissions. An income tax provision charged against realized gains should be disclosed separately. Gains arising from in-kind redemptions should be disclosed.

5.32 The 1940 Act requires the disclosure of proceeds from sales of securities and the cost of securities (other than U.S. government securities) bought.[132] It has become common practice to exclude short-term securities from this disclosure requirement. Purchases and sales of U.S. government obligations should be disclosed separately; information pertaining to common stocks, bonds, and preferred stocks may be combined or disclosed separately if such separate disclosure presents information about investment activities more meaningfully. Net realized gains or losses ordinarily are insignificant for money market and similar funds in relation to the total amounts of sales and maturities of portfolio securities, the funds' investment performance, or results of operations. If so, such net realized gains or losses may be combined with interest income for financial reporting.

Changes in Unrealized Appreciation or Depreciation of Investments

5.33 Changes in net unrealized appreciation or depreciation during the period should be reported in the statement of operations. A provision for deferred taxes on changes, if any, should be reported separately.

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[132] Section 30(d)(6) of the 1940 Act.

Net Gain or Loss on Investments

5.34 The sum of a net realized gain or loss and a change in unrealized gain or loss on investments should be presented in the statement of operations as a net gain or loss on investments. The effects of futures or options trading activities should be disclosed separately, if significant.

Net Increase or Decrease in Net Assets Resulting From Operations

5.35 The sum of investment income—net and net gain or loss on investment should be shown as a net increase or decrease in net assets resulting from operations.

Statement of Changes in Net Assets

5.36 The objective of the statement of changes in net assets is to summarize, in comparative form, changes in net assets resulting from operations, net equalization credits or debits, dividends to shareholders, and capital share transactions.

5.37 The increase or decrease in net assets comprises the following categories:

a. *Operations.* Net investment income or loss and net realized gains and losses and changes in unrealized gains or losses on investments, as shown in the statement of operations, should be presented separately to arrive at the net change in net assets resulting from operations.

b. *Net equalization debits or credits.* If equalization accounting is followed, undistributed investment income included in the price of capital shares issued or reacquired should be shown as a separate line item.

c. *Distributions to shareholders.* Presentation of the total amount of distributions declared during the period should be segregated between distributions from undistributed investment income and distributions from undistributed realized gains from investment transactions. Per share amounts of distributions declared may be disclosed in this statement. Investment companies often distribute, in the succeeding year, a portion of undistributed investment income and security gains realized in the preceding year. If declared, per share amounts relating to those distributions should be disclosed in the notes to the financial statements.

d. *Capital share transactions.* The net change in net assets (excluding amounts shown separately if equalization accounting is used) arising from capital share transactions should be disclosed. The components of the change should be disclosed on the face of the statement or in the notes as follows:

1. The number and value of shares sold
2. The number and value of shares issued in reinvestment of distributions
3. The number and value of shares reacquired
4. The net change

e. *Net assets.* Net assets should be disclosed at the beginning of the year and at the end of the year. The balance of net assets at the end of the year should agree with the comparable amount shown in the statement of assets and liabilities or in the statement of net assets, and should indicate the amount of undistributed investment income (usually parenthetically).

Supplementary Information

5.38 Selected per share data and ratios for a period of at least five years should be presented as supplementary information. Per share amounts presented are based on a share outstanding throughout the period.

5.39 The following per share information should be presented. (A more detailed discussion may be found in the instructions for preparation of registration statements on Form N-1A.)

a. Investment income

b. Expenses (income taxes and interest on borrowed funds should be reported separately, if material) [133]

c. Per share investment income—net, which is calculated by adding distributions per share paid during the year from undistributed investment income to the net change in undistributed investment income per share between the beginning and the end of the year

d. Distributions from undistributed investment income, undistributed net realized gain through investment transactions, and from other sources

e. Realized and unrealized gains and losses per share, which are balancing amounts necessary to reconcile the change in net asset value per share with the other per share information presented

f. The increase or decrease in net asset value for each period

g. The net asset value at the beginning and end of each period

As noted above, per share information is computed on the basis of guidelines contained in the SEC's instructions for preparing registration statements on Form N-1A. Though certain key per share information is calculated based on the SEC's instructions, it most often reasonably approximates amounts that would result from a more precise calculation. For example, by dividing investment income—net by the average or weighted average number of shares outstanding instead of by the method described above for calculating per share investment income—net. Sometimes, per share amounts calculated by using the SEC's instructions may be unreasonable. That usually occurs with relatively new entities. In those circumstances, per share information should be prepared by using the average or weighted average number of shares outstanding, and the method used should be disclosed in the per share table.

5.40 The ratios of investment income—net and expenses to average net assets should be presented. Some investment companies present other information in addition to those ratios and the per share data. That information sometimes includes a more detailed breakdown of expenses per share, average net assets for each of the periods presented, portfolio turnover rates, the number of shares outstanding at the end of each period, and total return or yield information for money market investment companies. Form N1-A requires disclosure of the portfolio turnover rate and number of shares at the

[133] The amounts to be disclosed in investment income and expenses are calculated by multiplying per share investment income—net (discussed in paragraph 5.30) by a ratio of the amounts in the comparable income and expense captions presented on the statement of operations.

end of each period in condensed financial information. The method of computing the portfolio turnover rate is described in Form N-SAR. Computational guidelines for determining yield are contained in SEC Release No. 6243. Total return represents the sum of the change in net asset value per share during the period and the value of reinvested cash distributions per share accumulated to the end of the period, divided by the net asset value per share at the beginning of the period.[134]

5.41 The per share amounts of distributions from undistributed net investment income of municipal bond funds should be stated separately for amounts applicable to taxable and tax-exempt dividends. Certain captions listed in paragraph 5.40 may not apply to certain types of funds, such as money market funds, and therefore should be omitted. A separate caption may be inserted to indicate the yield on a share of capital stock outstanding throughout each period. The basis on which the yield was calculated should be presented.

Interim Financial Statements

5.42 Although quarterly financial information may be less detailed than financial statements presented semiannually or annually, interim statements that purport to present net assets, results of operations, and changes in net assets should be complete and based on generally accepted accounting principles, which should conform to the principles used in preparing annual financial statements.

5.43 The statement of changes in net assets should present information on the latest interim period and the preceding fiscal year.

5.44 Unaudited interim financial data should be marked accordingly. Data summarized in condensed form should also be labeled. If the independent accountant is named or identified in interim reports on which he or she has performed no audit or review procedures, the accountant should insist that reference to self be deleted or that a disclaimer of opinion be included.[135]

Illustrative Financial Statements of Management Investment Companies

5.45 The amounts in the accompanying financial statements are illustrative only and may not indicate relationships among accounts. The financial statements illustrate the presentation of various items, if material. (Some items may not apply in some presentations and some may be combined and presented as one amount.)

5.46 To comply with SEC rules and regulations, registered investment companies must make certain disclosures in addition to those required by generally accepted accounting principles. Those additional requirements are not presented in illustrative financial statements because they are not otherwise required by generally accepted accounting principles. At the time of this guide's publication, such compliance disclosures consist of the following:

- The total cost, for federal income tax purposes, of the portfolio of investments according to rule 12-12 (note 8) of Regulation S-X concerning the schedule of statement investments.
- Additional disclosures required by rule 12-12 (note 2) of Regulation S-X pertaining to collateral for repurchase agreements, and by rule

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[134] A discussion of computational guidelines may be found in rule 205-1 of the Investment Advisers Act of 1940.

[135] SAS No. 26, *Association With Financial Statements.*

4-08(m) of Regulation S-X requiring certain additional disclosures if the carrying amounts of repurchase or reverse repurchase agreements exceed 10 percent of total assets or the amount at risk (as defined) under such agreements exceeds 10 percent of net asset value.

- Additional disclosures about restricted securities in accordance with the SEC's *Codification of Financial Reporting Policies,* section 404, and rule 12-12 (note 6) of Regulation S-X.
- The gross unrealized appreciation for all securities in which there is an excess of value over tax cost and gross unrealized depreciation for all securities in which there is an excess of tax cost over value, as well as net unrealized appreciation or depreciation according to rule 12-12 (note 8) of Regulation S-X.
- The average amount of borrowings outstanding during the period, the weighted average interest rate, and the maximum amount of debt outstanding during the period, according to rule 6-04.13(b), referring to rules 5-02.19(b) and 5-02.22(b), of Regulation S-X.
- The elements of net assets as required in regulations 210.6-04.16, 210.6-04.17, and 210.6-04.18 as part of the statement of assets and liabilities, rather than in the notes to the financial statements as shown in the illustrative financial statements for companies using a statement of net assets.

5.47 Although generally accepted accounting principles permit the use of either statement, the SEC rules under article 6 of Regulation S-X proscribe the use of a statement of net assets in place of a statement of assets and liabilities unless at least 95 percent of the amount of the investment company's total assets is represented by investments in securities of unaffiliated issuers. That restriction does not apply to a statement of net assets presented in conformity with generally accepted accounting principles. As discussed in the guide, the choice of whether to present a statement of assets and liabilities or a statement of net assets depends on which format more clearly portrays the information.*

* *Note:* The statement of net assets in the illustrative financial statements that follow presents investments in unaffiliated issuers that represent only 92 percent of total assets. An investment company registered with the SEC would be required to present a statement of assets and liabilities, including a separate schedule of investments, rather than a statement of net assets.

Exhibit 5.48

XYZ Management Investment Company
Statement of Assets and Liabilities
December 31, 19X4

Assets	
Investments in securities, at value—identified cost $19,294,000	$21,721,000
Cash	199,000
Deposits with brokers for securities sold short	1,555,000
Receivables	
Dividends and interest	46,000
Investment securities sold	24,000
Capital stock sold	54,000
Other assets	26,000
Total assets	23,625,000
Liabilities	
Covered call options written, at value—premiums received $110,000	230,000
Securities sold short, at value—proceeds $1,555,000	1,673,000
Demand loan payable to bank (Note 5)	2,000,000
Payable upon return of securities loaned (Note 9)	620,000
Payables	
Investment securities purchased	52,000
Capital stock reacquired	8,000
Other	4,000
Accrued taxes	8,000
Distribution payable	168,000
Total liabilities	4,763,000
Net Assets	
Net assets (equivalent to $4.47 per share based on 4,216,000 shares of capital stock outstanding) (Note 6)	$18,862,000

The accompanying notes are an integral part of these financial statements.

Note: A statement of assets and liabilities is an alternative presentation to a statement of net assets. The reader should be aware, however, that SEC rules do not always consider the two statement formats to be alternative presentations (see discussion in note following paragraph 5.47).

Exhibit

5.49

XYZ Management Investment Company

Investments in Securities

December 31, 19X4

[*Note:* Securities may be arranged by industry groupings or other groupings (showing percentage of total portfolio or of net assets invested in each grouping) that the company believes are most meaningful to users. The basis of the computation of percentages shown (which in this illustration is based on the ratio of the specific category of securities to the total portfolio owned) should be disclosed.]

	Principal Amount or Shares	*Value*
Common Stocks—54%		
Consumers' durable goods—5%		
Allied Manufacturing Corporation	25,000	$ 620,000
Baker Industries, Inc.	15,000	150,000
Etc. (other common stocks)		316,000
Consumers' nondurable goods—2%		
Amalgamated Buggy Whips, Inc. (Note 2)	10,000	280,000
Etc. (other common stocks)		155,000
Service industries—4%		
Service Company, Inc.	10,000	465,000
Etc. (other common stocks)		404,000
Etc. (other industry groupings)—43%		9,351,000
Total common stocks (cost $10,294,000)		11,741,000
Convertible bonds—25%		
American Retailing Inc.—5.5% debentures due 19XX	$500,000	525,000
Etc. (other convertible bonds)		4,875,000
Total convertible securities (cost $4,400,000)		5,400,000
U.S. government obligations—16%		
U.S. Treasury 6% notes due 20XX	$500,000	490,000
Etc. (other long-term government obligations)		2,985,000
Total U.S. government obligations (cost $3,500,000)		3,475,000
Short-term notes—3%		
Commercial Paper, Inc., due 2/5/X5	$500,000	505,000
U.S. Treasury bills, due 1/20/X5	$100,000	100,000
Total short-term notes (cost $600,000)		605,000

	Principal Amount or Shares	Value
Repurchase agreements collateralized by U.S. government obligations—2%		
Money Center Bank of Large City, 11%, due 1/3/X5 (cost $500,000)	$500,000	500,000
Total—100% (cost $19,294,000)		$21,721,000

The accompanying notes are an integral part of these financial statements.

Exhibit

5.50

XYZ Management Investment Company

Covered Call Options Written

December 31, 19X4

Common Stocks/Expiration Date/Exercise Price	*Shares Subject to Call*	*Value*
Allied Manufacturing Corporation/July/25	10,000	$ 50,000
Allied Manufacturing Corporation/October/30	5,000	2,500
Etc. (other options written)		177,500
Total (premiums received $110,000) (Note 3)		$230,000

Exhibit
5.51

XYZ Management Investment Company
Securities Sold Short
December 31, 19X4

Common Stocks	*Shares*	*Value*
International Widgets, Inc.	40,000	$ 425,000
Paper Airplane Corporation	25,000	265,000
Etc. (other common stocks)		983,000
Total (proceeds $1,555,000)		$1,673,000

The accompanying notes are an integral part of these financial statements.

Exhibit

5.52

XYZ Management Investment Company

Statement of Net Assets

December 31, 19X4

[*Note:* Securities may be arranged by industry or other groupings (showing the percentage of total portfolio or of net assets invested in each grouping) that the company believes will be most meaningful to the user.]

	Shares or Principal Amount	*Value*
Assets		
Investments in securities—115% of net assets		
Common stocks—62%		
Consumers' durable goods—6%		
Allied Manufacturing Corporation	25,000	$ 620,000
Baker Industries, Inc.	15,000	150,000
Etc. (other common stocks)		316,000
Consumers' nondurable goods—2%		
Amalgamated Buggy Whips, Inc. (Note 2)	10,000	280,000
Etc. (other common stocks)		155,000
Service industries—5%		
Service Company Inc.	10,000	465,000
Etc. (other common stocks)		404,000
Etc. (other industry groupings)—49%		9,351,000
Total common stocks (cost $10,294,000)		11,741,000
Convertible bonds—29%		
American Retailing Inc.—5.5% debentures due 19XX	$500,000	525,000
Etc. (other convertible bonds)		4,875,000
Total convertible bonds (cost $4,400,000)		5,400,000
U.S. government obligations—18%		
U.S. Treasury—6% notes due 20XX	$500,000	490,000
Etc. (other long-term obligations)		2,985,000
Total U.S. government obligations (cost $3,500,000)		3,475,000
Short-term notes—3%		
Commercial Paper, Inc., due 2/5/X5	$500,000	505,000
U.S. Treasury bills, 1/20/X5	$100,000	100,000
Total short-term notes (cost $600,000)		605,000
Repurchase agreement collateralized by U.S. government obligations—3%		
Money Center Bank of Large City—11% due 1/3/X5 (cost $500,000)	$500,000	500,000

	Shares or Principal Amount	Value
Total investments in securities (cost $19,294,000)		21,721,000
Other assets—10%		1,904,000
Total assets		23,625,000
Liabilities		
Demand loans payable to bank—10% (Note 5)		2,000,000
Securities sold short—9%		1,673,000
Other liabilities—6%		1,090,000
Total liabilities		4,763,000
Net Assets		
Net assets (equivalent to $4.47 per share based on 4,216,000 shares of capital stock outstanding) (Note 6)		$18,862,000

The accompanying notes are an integral part of these financial statements.

Note: A statement of assets and liabilities is an alternative presentation to a statement of net assets. The reader should be aware, however, that SEC rules do not always consider the two statement formats to be alternative presentations (see discussion in note following paragraph 5.47).

Exhibit

5.53

XYZ Management Investment Company

Statement of Operations

Year Ended December 31, 19X4

Investment income		
Income		
Dividends	$742,000	
Interest	259,000	
Total income		$ 1,001,000
Expenses		
Investment advisory fee (Note 8)	90,000	
Interest	55,000	
Professional fees (Note 8)	29,000	
Custodian and transfer agent fees	12,000	
Distribution expenses (Note 8)	4,000	
State and local taxes other than income taxes	15,000	
Directors' fees	12,000	
Dividends on securities sold short	9,000	
Total expenses		226,000
Investment income—net		775,000
Realized and unrealized gain (loss) on investments (Note 7)		
Net realized gain on investments		1,089,000
Change in unrealized appreciation of investments for the year		(1,649,000)
Net loss on investments		(560,000)
Net increase in net assets resulting from operations		$ 215,000

The accompanying notes are an integral part of these financial statements.

Exhibit

5.54

XYZ Management Investment Company

Statements of Changes in Net Assets

Years Ended December 31, 19X4 and 19X3

	19X4	*19X3*
Increase (decrease) in net assets from operations		
Investment income—net	$ 775,000	$ 492,000
Net realized gain on investments	1,089,000	1,000,000
Change in unrealized appreciation	(1,649,000)	1,551,000
Net increase in net assets resulting from operations	215,000	3,043,000
Net equalization credits	9,000	6,000
Distributions to shareholders from—		
Investment income—net	(525,000)	(350,000)
Net realized gain on investments	(1,350,000)	(1,066,000)
Capital share transactions	2,721,000	1,749,000
Total increase	1,070,000	3,382,000
Net assets		
Beginning of year	17,792,000	14,410,000
End of year (including undistributed investment income of $639,000 and $380,000, respectively)	$18,862,000	$17,792,000

The accompanying notes are an integral part of these financial statements.

Exhibit

5.55

XYZ Management Investment Company

Notes to Financial Statements

The following notes to the financial statements are illustrative only. In some circumstances, the information may be better presented within the financial statements; in other circumstances, information not required by regulation may not be sufficiently material to be disclosed.

1. *Significant Accounting Policies*

The Company is registered under the Investment Company Act of 1940 as a diversified, open-end management investment company.

Security valuation. Investments in securities traded on a national securities exchange (or reported on the NASDAQ national market) are stated at the last reported sales price on the day of valuation; other securities traded in the over-the-counter market and listed securities for which no sale was reported on that date are stated at the last quoted bid price, except for short positions and call options written, for which the last quoted asked price is used. Short-term notes are stated at amortized cost, which is equivalent to value. Restricted securities and other securities for which quotations are not readily available are valued at fair value as determined by the board of directors.

Federal income taxes. The Company's policy is to comply with the requirements of the Internal Revenue Code that are applicable to regulated investment companies and to distribute all its taxable income to its shareholders. Therefore, no federal income tax provision is required.

Equalization. The Company uses the accounting practice of *equalization,* by which a portion of the proceeds from sales and costs of redemption of capital shares, equivalent on a per share basis to the amount of undistributed net investment income on the date of the transactions, is credited or charged to undistributed income. As a result, undistributed net investment income per share is unaffected by sales or redemptions of capital shares.

Distributions to shareholders. Dividends to shareholders are recorded on the ex-dividend date.

Other. The Company follows industry practice and records security transactions on the trade date. Dividend income is recognized on the ex-dividend date, and interest income is recognized on an accrual basis. Discounts and premiums on securities purchased are amortized over the life of the respective securities.

2. *Restricted Securities*

The investment in 10,000 shares of Amalgamated Buggy Whips, Inc. common stock, the sale of which is restricted, has been valued by the board of directors after considering certain pertinent factors, including the results of operations of Amalgamated since the date of purchase in 19X1 and the sales price of recent private placements in its common stock. There is no quoted market for Amalgamated shares.*

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* If several restricted security investments are held, a general statement on the valuation methods may be given rather than individual descriptions.

3. *Covered Call Options Written*

As of December 31, 19X4, portfolio securities valued at $1,908,000 were held in escrow by the custodian in connection with covered call options written by the Company.

4. *Distributions to Shareholders*

On January 3, 19X5, a distribution of $0.20 aggregating $840,000 was declared from net realized gains from investment transactions (including $0.02 applicable to short-term gains that are taxable to shareholders as ordinary income dividends) during 19X4. The dividend was paid on January 20, 19X5, to shareholders of record on January 10, 19X5.

As of December 31, 19X4, the Company had available for federal income tax purposes an unused capital loss carryover of approximately $1,500,000, which will expire in 19X5.†

5. *Bank Loans*

The Company has an unsecured $3,000,000 bank line of credit; borrowings under this arrangement bear interest at 110 percent of the bank's prime rate. As of December 31, 19X4, the Company was paying interest at 11 percent per year on its outstanding borrowings. No compensating balances are required.

6. *Capital Share Transactions*

As of December 31, 19X4, there were 25,000,000 shares of $0.50 par value capital stock authorized and capital paid-in aggregated $15,184,000.

Transactions in capital stock were as follows:

	Shares		*Amount*	
	19X4	*19X3*	*19X4*	*19X3*
Shares sold	452,000	329,000	$2,177,000	$1,434,000
Shares issued in reinvestment of dividends	222,000	207,000	1,000,000	845,000
	674,000	536,000	3,177,000	2,279,000
Shares redeemed	104,000	121,000	456,000	530,000
Net increase	570,000	415,000	$2,721,000	$1,749,000

7. *Investment Transactions*

Purchases and sales of investment securities (excluding short-term securities) were $32,000,000 and $23,300,000, respectively, for common stocks and bonds; purchases and sales of U.S. government obligations were $3,300,000 and $2,000,000. Net loss on investments for the year ended December 31, 19X4, was $560,000. That amount represents the net decrease in value of investments held during the year. The components are as follows:

† This would be disclosed if the Company had an available capital loss carryover as of December 31, 19X4.

Long transactions	$(501,000)
Short sale transactions	(75,000)
Covered call options written	16,000
	$(560,000)

As of December 31, 19X4, the unrealized appreciation of securities was $2,189,000; accumulated undistributed net realized gains on investment transactions totaled $850,000.

8. *Investment Advisory Fees and Other Transactions With Affiliates*

The Company pays advisory fees for investment management and advisory services under a management agreement (Agreement) that provides for fees to be computed at an annual rate of 0.5 percent of the Company's average daily net assets. Certain officers and directors of the Company are also officers and directors of the investment adviser. The Agreement provides for an expense reimbursement from the investment adviser if the Company's total expenses, exclusive of taxes, interest on borrowings, dividends on securities sold short, brokerage commissions, and extraordinary expenses, exceed 1.5 percent of the Company's average daily net assets for any full fiscal year. An expense reimbursement was not required for either 19X4 or 19X3. An expense reimbursement of $0.01 per share was required in 19X0.

The investment adviser also received $10,000 in 19X4 and $15,000 in 19X3 from commissions earned on sales of XYZ Management Investment Company capital stock and $5,000 in 19X4 and $8,000 in 19X3 from brokerage fees on its executions of purchases and sales of portfolio investments.

During 19X4, the Company incurred legal fees of $7,000 to Brown and Smith, counsel for the Company. John F. Smith, a partner of the firm, is a director of the Company. MNO Service Company, an affiliate of the investment adviser, received $4,000 in expense reimbursements for shareholder-related distribution expenses undertaken pursuant to a shareholder-approved plan.

9. *Portfolio Securities Loaned*

As of December 31, 19X4, the Company loaned common stocks having a value of approximately $570,000 and received cash collateral of $620,000 for the loan.

Exhibit

5.56

Supplementary Information—Selected Per Share Data and Ratios*

	19X4	19X3	19X2	19X1	19X0
Per Share Data					
Investment income	$ .27	$ .30	$ .24	$ .20	$ .18
Expenses	.06	.10	.05	.03	.03†
Investment income—net	.21	.20	.19	.17	.15
Distributions from investment income—net	(.16)	(.16)	(.17)	(.17)	(.15)
Net realized and unrealized gain (loss) on securities	(.12)	.71	.52	(.42)	.48
Distributions from realized gains on securities	(.34)	(.33)	(.24)	(.23)	(.20)
Net increase/decrease in net asset value	(.41)	.42	.30	(.65)	.28
Net asset value:					
Beginning of year	4.88	4.46	4.16	4.81	4.53
End of year	$4.47	$4.88	$4.46	$4.16	$4.81
Ratios					
Ratio of expenses to average net assets (%)	1.33	1.31	.99	.82	.84
Ratio of investment income—net to average net assets (%)	4.56	2.82	4.22	5.42	5.10

* Selected data for a share of capital stock outstanding throughout the year.
† See Note 8 of the notes to financial statements.
[*Note:* See paragraph 5.40 for a discussion of additional information that may be included in this schedule.]

Chapter 6

Unit Investment Trusts

6.01 A unit investment trust is an investment company organized under a trust agreement and indenture or similar instrument among the sponsor, the trustee, and the evaluator. It has no board of directors, and issues only redeemable units of undivided interest or shares of beneficial interest, each representing a fractional undivided interest in the trust's portfolio of investment securities. Units remain outstanding until a unit holder tenders them to the trustee for redemption or until the trust is terminated. Trust agreements usually require periodic distribution pro rata to the unit holders of dividends in the amount of the trust's entire net income and capital gains, if any, and distribution of the proceeds of redemptions, maturities, or sales of obligations in the trust, unless the proceeds are used to pay for units to be redeemed.

6.02 A unit investment trust is one of the three basic types of investment companies defined by the 1940 Act, as amended. The unit trust form is used primarily as an investment vehicle to (a) hold a portfolio of tax-exempt bonds, money market instruments, corporate bonds, and preferred stocks or other types of securities, or (b) hold the shares of a particular management investment company being accumulated under a contractual plan. (See chapter 7 for a discussion of unit trusts as funding media for variable annuity contracts.) The form and content of financial statements of publicly held unit investment trusts are prescribed by article 6 of Regulation S-X and the financial schedules by rules 6-10(d) and 12-12 of Regulation S-X.

6.03 The discussion in this chapter is restricted to bond and fixed income unit trusts and contractual plans because the majority of unit trusts and contractual plans are of those types. The accounting and auditing procedures for unit trusts are generally similar to those for other investment companies described in the guide.

Bond and Fixed Income Unit Trusts

6.04 Shares in unit trusts representing self-liquidating pools of tax-exempt or taxable bonds or other taxable fixed income securities held in custody by a corporate trustee were first offered to the investing public in the early 1960s. Sales of shares of beneficial interest in such unit trusts increased significantly in the 1970s when bond yields rose in response to a rapid increase in interest rates.

6.05 The principal objectives of bond and fixed income unit investment trusts are to generate a consistent income stream that may be taxable or tax-exempt and to preserve principal by investing in a diversified portfolio of securities.

6.06 A sponsoring organization, such as an investment banking firm, initiates a unit trust by accumulating a group of securities of a type specified in the trust indenture. Portfolios may range in value from a few million dollars to $100 million or more and may consist of many individual issues. A tax-exempt portfolio may be diversified by economic activity (such as education, health care, and housing) or geographic area, or it may be concentrated in a particular state to provide investors with income exempt from federal and state income taxes. The portfolio may be accumulated by the sponsor over a period ranging from a few days to several weeks. At the deposit date, the portfolio of securities is conveyed to a corporate trustee at offering prices defined in the trust agreement (usually, based on offering prices rather than bid prices), as determined by an independent evaluator retained by the sponsor. Either an irrevocable letter of credit or a check is issued by a commercial bank and delivered to the corporate trustee to cover the cost and accrued interest to settlement dates of portfolio securities that are not delivered to the corporate trustee on the deposit date. Securities offered on a when-issued basis, delayed deliveries, or the normal settlement process may cause delayed deposits. An auditor normally audits a unit investment trust as of the opening of business on the date of deposit.

6.07 The sponsoring company, its underwriters, or both sell units of undivided interest at their public offering price, which is equal to the total of the offering prices of the underlying securities owned by the trust, including accrued interest, and other assets, if any, divided by the number of units outstanding plus a sales charge. The sales charge is a percentage of net asset value of the trust unit, excluding accrued interest. Many or all of the units of participation are usually placed by soliciting those who indicated an interest in the preliminary prospectus. On the formation of the trust, the sponsor may realize a profit or loss on the sale of the portfolio to the trust. The profit or loss represents the difference between the aggregate cost of the portfolio to the sponsor and the aggregate offering side valuation on the date of deposit. The initial schedule of investments should disclose the aggregate cost of the securities and the related net gain or loss to both the sponsor and the trust.

6.08 A bond and fixed income unit investment trust does not offer participation units continuously. However, the sponsor usually maintains a secondary market by repurchasing units from investors at prices based on the total bid prices of the underlying securities and by reoffering them at prices based on the current offering prices of the underlying securities and sales charges. Alternatively, an investor can ask the trustee to redeem his or her units at a redemption price, which is usually based on the bid prices of the underlying securities.

6.09 After the initial syndication by the sponsoring entity, all accounting, record-keeping, and income-distribution services are maintained by the trustee. The trustee distributes the accumulated income to unit holders at least semiannually and sometimes quarterly or monthly. Usually, as bonds are redeemed or as they mature, the proceeds are distributed to unit holders rather than reinvested in other investment securities.

6.10 The trustee reports to unit holders periodically on the values of the underlying securities and on certain other financial information relating to the trust, as required by the trust agreement. The valuation policies are similar to those used by management investment companies. Financial statements are usually not distributed to unit holders; however, unaudited year-end distribution information is supplied by the sponsor or trustee. The trust agreement specifies the reporting of tax and other information.

6.11 Some or all of the debt securities owned by certain trusts are covered by insurance obtained by the issuer or the trust to guarantee principal and interest payments when due. The valuation of securities in an insured portfolio is discussed in chapter 2.

Taxes

6.12 Unit investment trusts consisting of taxable securities usually try to qualify as regulated investment companies under subchapter M of the Code by complying with the applicable requirements. They generally distribute dividends in the amounts of all their taxable income and gains from sales of securities and are therefore not subject to federal income taxes. Conversely, unit investment trusts comprised of tax-exempt securities are usually organized as grantor trusts.

6.13 If more than 50 percent of a unit investment trust's total assets consists of securities—on which interest is exempt from federal income taxes under existing law when received by a trust—such interest retains its tax-exempt status when dividends are distributed to unit holders in the amount of the interest. Amounts realized from capital gains and paid to unit holders by the trust are taxable to the individual. (Chapter 4 discusses taxes in more detail.)

Illustrative Financial Statements

6.14 The financial statements of unit investment trusts are similar to those of management investment companies. When a trust is formed, the financial statements filed with the SEC of Form S-6 [136] include a statement of assets and liabilities and a schedule of investments. Subsequently, if the sponsor repurchases and reoffers trust units in the secondary market, a posteffective amendment to Form S-6 must be filed periodically with the SEC. The financial statements included in the posteffective amendment, which are prepared in accordance with Regulation S-X, are a statement of assets and liabilities, a schedule of investments, a statement of operations, and a statement of changes in net assets. Audited financial statements are provided to prospective investors and generally to existing investors in the prospectus. Form S-6 requires that both the statement of operations and statement of changes in net assets cover a three-year period.

6.15 Certain disclosures required of registered investment companies for compliance with SEC rules and regulations are not presented in the illustrative financial statements because they are not otherwise required by generally accepted accounting principles. Such compliance disclosures consist of—

a. The aggregate cost, for federal income tax purposes, of the portfolio of investments according to rule 12-12 (note 8) of Regulation S-X.

b. The gross unrealized appreciation for all securities in which there is an excess of value over tax cost, and gross unrealized depreciation for all securities in which there is an excess of tax cost over value according to rule 12-12 (note 8) of Regulation S-X.

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[136] See footnote 7 to chapter 1.

Exhibit

6.16

Anytown Income Trust

First Intermediate Series

Statement of Assets and Liabilities

August 31, 19X4

Trust Property

Assets	
Investments in securities at market value (cost $14,591,035) (Note 1 and Schedule I)	$13,878,788
Interest receivable (Note 1)	339,174
Cash	166,489
Total	14,384,451
Liabilities and Net Assets	
Liabilities	
Trustee and evaluator fees payable	47
Accrued other expenses payable	475
Total liabilities	522
Net Assets	
Balance applicable to 15,500 units of fractional undivided interest outstanding (Notes 1 and 3)	
Capital, less unrealized depreciation of investments of $712,247	13,878,788
Balance of distributable funds (applicable to unit holders)	505,141
Net assets	$14,383,929
Value per unit (15,500 units)	$ 928

The accompanying notes are an integral part of these financial statements.

Exhibit 6.17

Anytown Income Trust
First Intermediate Series
Portfolio of Corporate Securities
August 31, 19X4

Name of issuer and title of issue	*Coupon Rate (%)*	*Date of Maturity or Final Sinking Fund Payment*	*Principal Amount or Par Value — Balance at August 31, 19X4*	*Value — Balance at August 31, 19X4*	
Corporate debt obligations					
Air transport					
Flying Tiger Lines Incorporated equipment trust certificates	9.000	10/01/X1	$ 931,000	$ 912,380	
Total air transport (percentage of total)			931,000	912,380	(6.6%)
Banking					
Dominion Bankshares notes	9.500	4/01/X3	1,000,000	1,022,500	
First Maryland Bancorp notes	9.750	11/01/X3	250,000	252,500	
Southeast Banking Corporation notes	10.000	5/01/X3	218,000	224,267	
Total banking (percentage of total)			1,468,000	1,499,267	(10.8%)
Utilities					
Utah Power & Light Company first-mortgage bonds	4.500	6/01/X2	100,000	65,125	
Total utilities (percentage of total)			100,000	65,125	(.5%)
Total debt obligations			$15,260,000	$13,878,788	

The accompanying notes are an integral part of these financial statements.

Exhibit

6.18

Anytown Income Trust

First Intermediate Series

Statements of Operations

(For the period from the date of deposit, March 23, 19X3, through August 31, 19X3, and for the year ended August 31, 19X4)

	For the Year Ended August 31, 19X4	*From March 23, 19X3, Through August 31, 19X4*
Investment income		
Interest income (Note 1)	$1,258,975	$554,509
Expenses (Note 1)		
Trustee's fee	14,063	5,411
Evaluator's fee	1,350	375
Other	1,083	351
Total expense	16,496	6,137
Investment income—net	1,242,479	548,372
Realized and unrealized gain (loss) on investments		
Realized losses from securities transactions	(12,738)	(12,765)
Unrealized appreciation (depreciation) during the period	(738,828)	26,581
Net gain (loss) on investments	(751,566)	13,816
Net increase in net assets resulting from operations	$ 490,913	$562,188

The accompanying notes are an integral part of these financial statements.

Exhibit

6.19

Anytown Income Trust

First Intermediate Series

Statements of Changes in Net Assets

(For the period from the date of deposit, March 23, 19X3, through August 31, 19X3, and for the year ended August 31, 19X4)

	For the Year Ended August 31, 19X4	*From March 23, 19X3, Through August 31, 19X4*
Increase (decrease) in net assets from operations		
Investment income—net	$ 1,242,479	$ 548,372
Net realized losses on investment sold	(12,738)	(12,765)
Net unrealized market appreciation (depreciation)	(738,828)	26,581
Net increase in net assets resulting from operations	490,913	562,188
Distributions to unit holders		
Distributions to unit holders (declared and paid $88.10 and $33.94 per unit, respectively) (Note 2)		
Accrued income as of the date of deposit	5,182	360,787
Investment income—net	1,231,408	54,303
Proceeds from the disposition of investments	129,000	110,999
Total distributions	1,365,590	526,089
Increase (decrease) in net assets	(874,677)	36,099
Net assets		
Beginning of year	15,258,606	15,222,507
End of year (including $505,140 in 19X4 and $494,069 in 19X3 of undistributed net investment income)	$ 14,383,929	$ 15,258,606

The accompanying notes are an integral part of these financial statements.

Exhibit

6.20

Anytown Income Trust

First Intermediate Series

Notes to Financial Statements

1. *Summary of Significant Accounting Policies*

The Trust was organized on March 23, 19X3, under the laws of the Commonwealth of Massachusetts by a Trust Indenture and Agreement, and is registered under the Investment Company Act of 1940. The significant accounting policies of the Trust include the following.

Basis of presentation. The Trust maintains its books on a cash basis; the accompanying financial statements have been adjusted to record the unrealized appreciation (depreciation) of investments and to record expenses and interest income on the accrual basis.

Investments in marketable securities. Security transactions are recorded on the trade date. Investments owned are carried at market value, which is the closing bid price on the last day of trading during the period, except that value on the date of deposit (March 23, 19X3) represents the cost to the Trust based on offering prices for investments at that date. The difference between cost and market value is reflected as unrealized appreciation (depreciation) of investments. Realized gains (losses) from securities transactions are determined for federal income tax and for financial reporting purposes on the basis of the cost of specified certificates.

Income taxes. No provision for federal income taxes has been made in the accompanying financial statements because the Trust intends to qualify for and elect the tax treatment applicable to regulated investment companies under the Internal Revenue Code. Under existing law, if the Trust so qualifies, it will not be subject to federal income tax on net income and capital gains that are distributed to unit holders.

Investment expenses. The Trust pays a fee for trustee services to XYZ Bank that is based on $0.75 per $1,000 of outstanding investment principal. In addition, a fixed fee of $35 is paid to a service bureau for portfolio valuation at least weekly and more often at the discretion of the trustee.

2. *Distributions of Income and Redemption of Units*

The Trust Agreement requires that the net income and net realized capital gains (if any) of the Trust, as well as the proceeds from the sale, redemption, or maturity of securities (to the extent that the proceeds are not used to redeem units), be distributed to unit holders monthly. Because interest on the securities in the Trust is payable at varying intervals, and distributions of income are made monthly to unit holders, the monthly income distribution may not be equal to the amount of money received. To eliminate fluctuations in monthly income distributions as a result of such variances, the trustee is required by the Trust Agreement to advance amounts necessary to provide monthly income distributions of approximately equal amounts. The trustee is reimbursed for advances, without interest, from funds subsequently received.

The Agreement also requires the Trust to redeem units tendered for redemption at a price determined on the basis of bid prices of the securities of the Trust. No units were sold or redeemed by the trustee during the period from the date of deposit (March 23, 19X3) through August 31, 19X4.

3. *Original Cost to Unit Holders*

The original cost to investors [137] represents the aggregate initial offering price as of the date of deposit exclusive of accrued interest, computed on the basis set forth in this prospectus. A reconciliation of the original cost of units to investors to the net amount applicable to investors as of August 31, 19X4, is set forth below.

Original cost to investors	$ 15,475,560
Less—	
Gross underwriting commissions	(619,022)
Cost of securities sold or redeemed since date of deposit	(265,503)
Net unrealized depreciation of securities	(712,247)
Net amount applicable to investors	$ 13,878,788

4. *Supplementary Information* [138]

Selected data for a unit of the Trust outstanding throughout each period follows.

	19X4	*19X3*
Interest income	$ 81.22	$ 35.77
Expenses	1.06	.39
Investment income—net	80.16	35.38
Income distributions	(79.44)	(3.50)
	.72	31.88
Accrued income and principal distributions	(8.66)	(30.44)
Net realized (loss) and change in unrealized (depreciation)	(48.49)	.89
Increase (decrease) in net asset value	(56.43)	2.33
Net asset value, beginning of the period	984.43	982.10
Net asset value, end of the period, including distributable funds	$ 928.00	$ 984.43

Contractual Plans

6.21 A contractual plan, which is a form of unit investment trust that invests in shares issued by a management investment company, is an accumu-

[137] This information is required by Regulation S-X and is not otherwise required by generally accepted accounting principles.

[138] If Trust units are redeemed at other than net asset value, the effect of such redemptions should be considered in calculating the per unit information.

lation plan specifying the total intended investment amount, a stated pay-in period, and provisions for regular monthly or other periodic payments by the investor. Such plans provide a systematic means of investing regularly in the shares of a particular management investment company. Payments, less sales charges, custodian fees, and insurance premiums, are invested in management investment company shares at net asset value as received. A substantial portion of the sales charge, applicable to the total amount to be invested, is usually deducted from the first year's payments (*front-end load*) or the first three years' payments (*spread load*).

6.22 A contractual plan is usually formed by a sponsor corporation to provide investors with a systematic investment plan. The sponsor acts for the investors in establishing the custodian agreement, arranging for a group life insurance policy for insured plans, selling the plans, and preparing such documents as the prospectuses and annual reports (Form N-SAR) for the SEC. Investors who agree to pay a lump sum to a single payment plan or a series of monthly amounts over a specified period to a periodic payment plan are the second parties to the plan. The third party to the plan is the custodian, who receives the planholders' payments, holds the trust's assets, and may also act as servicing agent, if required under the agreement. When acting in the capacity of servicing agent, the custodian processes planholders' payments, maintains planholders' accounts, credits dividends and distributions, processes partial and full liquidations, and deducts and pays insurance premiums for insured accounts.

6.23 Some custodians maintain inception-to-date historical information for each plan account. However, average-cost records or the cost of shares to the entire plan may also be maintained.

6.24 Contractual plans differ in concept and financial statement presentation from unit investment trusts. All of a contractual plan's assets consist of securities issued by a single management investment company, whereas a unit investment trust's assets consist of a number of portfolio securities.

Taxes

6.25 The Code, as amended, provides that contractual plans should not be treated as separate taxable entities. They therefore have no liabilities for federal taxes and are not required to file tax returns. For federal tax purposes, investors are deemed to be the owners of the underlying fund shares accumulated in their accounts. Consequently, federal income taxes apply to dividends received by investors. Chapter 4 has an additional discussion on taxes.

Illustrative Financial Statements

6.26 A contractual plan's audited financial statements are presented in the plan prospectus but are not usually sent to existing planholders, who instead receive the annual and semiannual reports of the underlying management investment company in which they are accumulating shares. The sponsor's audited financial statements are also required to be included in the prospectus.

6.27 Information in financial statements is usually presented for single payment plans, monthly payment plans with insurance, and monthly payment plans without insurance. It is preferable, however, to present single and monthly payment plans as separate series, because the insurance feature is an option available only to monthly payment planholders. It is not unusual for insured plans to become uninsured plans by request or default (sometimes with subsequent reinstatement of insurance) so that reporting of those plans as different series need not be done.

6.28 The financial statements present information about the entire plan, and their format is similar to that used for management investment companies.

Exhibit

6.29

XYZ Sponsors Corporation
Systematic Investment and
Single-Payment Investment Plans
for the Accumulation of Shares of
Sample Fund, Inc.
Statement of Assets and Liabilities
September 30, 19X4

Assets		
Sample Fund, Inc. shares, at value (identified cost $1,954,607)		$1,958,578
Cash		9,000
Total assets		1,967,578
Liabilities		
Payable for Sample Fund, Inc. shares purchased	$3,200	
Planholders' prepayments of life insurance premiums	4,500	
Custodian fees payable	1,000	
Sponsor fees payable	300	
Total liabilities		9,000
Net Assets		
Net assets (equivalent to $6.73 per share based on 291,022 shares of capital stock owned on outstanding plans)		$1,958,578

The accompanying notes are an integral part of these financial statements.

Exhibit 6.30

XYZ Sponsors Corporation
Systematic Investment and Single-Payment Investment Plans for the Accumulation of Shares of Sample Fund, Inc.
Statement of Operations
Year Ended September 30, 19X4

Investment income		
Distributions received on shares of Sample Fund, Inc. from—		$ 51,942
Net investment income		96,571
Realized gains		148,513
Expenses		
Custodian fees	$5,000	
Delegated service fees	2,000	
Total expenses		7,000
Investment income—net		141,513
Realized and unrealized gain (loss) on investments		
Realized gains on complete and partial liquidations, including shares delivered to planholders	9,899	
Unrealized appreciation (depreciation) during the year	5,164	
Net realized and unrealized gain on plan shares		15,063
Net increase in net assets resulting from operations		$156,576

The accompanying notes are an integral part of these financial statements.

Exhibit

6.31

XYZ Sponsors Corporation
Systematic Investment and
Single-Payment Investment Plans
for the Accumulation of Shares of
Sample Fund, Inc.
Statements of Changes in Net Assets
Years Ended September 30, 19X4 and 19X3

	19X4	*19X3*
Increase (decrease) in net assets from:		
Investment income—net	$ 141,513	$ 51,700
Realized gain on plan liquidations	9,899	5,204
Unrealized appreciation (depreciation) on plan shares held	5,164	(1,557)
	156,576	55,347
Distributions to planholders from investment income—net	(141,513)	(51,700)
Capital share transactions—net (Note 2)	1,172,589	735,316
Net increase in net assets	1,187,652	738,963
Net assets		
Beginning of year	770,926	31,963
End of year	$1,958,578	$ 770,926

The accompanying notes are an integral part of these financial statements.

Exhibit

6.32

XYZ Sponsors Corporation
Systematic Investment and
Single-Payment Investment Plans
for the Accumulation of Shares of
Sample Fund, Inc.
Notes to Financial Statements

1. ***Significant Accounting Policies***

The Plan is a unit investment trust registered under the Investment Company Act of 1940. The following significant accounting policies, which are in conformity with generally accepted accounting principles for unit investment trusts, are consistently used in the preparation of its financial statements.

Security valuation. Investments are valued at the net asset value of fund shares held.

Transaction dates. Shares transactions are recorded on the trade dates. Income and capital gains distributions are recorded on the ex-dividend dates.

Income taxes. No provision is made for federal income tax. All distributions of net investment income and capital gains received by planholders are treated as if received directly from the underlying Fund. A planholder realizes a gain or loss on liquidation for cash but not on withdrawal of the underlying Fund shares.

2. *Capital Shares*

As of September 30, 19X4, the plan held 291,022 shares of Sample Fund, Inc. Capital transactions in Sample Fund, Inc. shares were as follows:

	19X4		*19X3*	
	Amount	*Shares*	*Amount*	*Shares*
Planholder payments	$1,655,225		$1,056,300	
Less—				
Sales charges	530,439		338,309	
Custodian fees	18,366		11,720	
Insurance premiums	4,573		3,108	
	553,378		353,137	
Balance invested in Sample Fund, Inc. shares	1,101,847	162,104	703,163	106,500
Shares of Sample Fund, Inc. acquired on reinvestment of distributions received	131,766	21,133	48,078	7,732
Redemptions and cancellations of Sample Fund, Inc. shares	(61,024)	(9,022)	(15,925)	(2,427)
Net increase	$1,172,589	174,215	$ 735,316	111,805

3. *Planholders' Cost of Sample Fund Shares*

The investment in Sample Fund, Inc. shares is carried at identified cost, which represents the amount available for investment (including reinvested distributions of net investment income and realized gains) in such shares after deduction of sales charges, custodian fees, and insurance premiums, if applicable.

The totals for each plan type are listed below:

Plans Outstanding

September 30, 19X4

	Monthly Payment Plans	*Single Payment Plans*	*Total*
Total payments made by planholders on plans outstanding	$1,811,473	$1,116,634	$2,928,107
Reinvested distributions from—			
Net investment income	44,838	17,215	62,053
Realized gains	68,220	52,838	121,058
Total	1,924,531	1,186,687	3,111,218
Deductions			
Sales charges	538,195	199,337	737,532
Custodian fees	198,504	—	198,504
Insurance premiums	6,372	—	6,372
Total deductions	743,071	199,337	942,408
Net investment in Sample Fund, Inc. shares	1,181,460	987,350	2,168,810
Less: Cost of partial withdrawals	126,838	87,365	214,203
Net cost of Sample Fund, Inc. shares	1,054,622	899,985	1,954,607
Unrealized appreciation	2,883	1,088	3,971
Net amount applicable to planholders	$1,057,505	$ 901,073	$1,958,578

Chapter 7

Variable Annuity Separate Accounts

7.01 This chapter discusses variable annuity separate accounts of life insurance companies. Separate accounts, also known as variable accounts, are used to support variable annuity contracts and variable life insurance policies. Separate accounts are registered investment companies under the 1940 Act, without an applicable exemption. A variable annuity is both a security registered under the Securities Act of 1933 (without an applicable exemption) and an annuity policy filed with and approved and regulated by state insurance departments.[139]

7.02 A variable annuity is a contractual arrangement that combines some features of an investment company's products (the contract holder assumes the risk of investment gain or loss) with certain traditional insurance features (the insurance company provides certain insurance guarantees and assumes the risk of mortality and administrative expenses). A significant difference between a traditional or fixed annuity and a variable annuity is that, in sponsoring a fixed annuity, the insurance company assumes the risk of investment gain or loss and guarantees the contract holder a specified interest rate and monthly annuity payment. In a variable annuity, the contract holder assumes the risk of investment gain or loss because the value of the individual account varies with the investment experience of a specific portfolio of securities (that is, the securities held in the separate account). In both, the insurance company generally assumes the mortality risk and administrative expenses for a contractually fixed fee or fees.

7.03 Variable annuities are funded by and issued through separate accounts of insurance companies. A registered separate account is either an open-end investment company or a unit investment trust. A separate account is not a legal entity, but an accounting entity with accounting records for variable annuity assets, liabilities, income, and expenses that are segregated as a discrete operation within the insurance company. The insurance company's other separate accounts and its general account do not affect the results of the variable annuity separate account. The combined separate accounts must file an annual statement with state insurance regulatory authorities. The separate account is not taxed separately for federal and state tax purposes; it is included with the operations of the insurance company. However, for purposes of the 1940 Act, a separate account is an independent entity, separate from the insurance company, and cannot rely on the 1940 Act's exemption for insurance companies.

7.04 The following three approaches are used to invest the underlying assets of variable annuity contracts:

a. Direct investment by the variable annuity separate account in individual securities (if the separate account is an open-end investment company)

b. Investment in a registered investment company formed to receive proceeds from such contract holders (if the separate account is a unit investment trust)

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[139] This chapter does not apply to variable life products, such as life insurance in which policy benefits vary with investment performance, the investments of which are also held in separate investment accounts. Variable life products are new products of the life insurance industry. Their design and applicable requirements are still evolving. Though variable life products are not discussed in this guide, auditors may find the guidance in this chapter helpful in dealing with variable life separate accounts.

c. Investment in a registered investment company that generally sells shares to the public (if the separate account is a unit trust)

The third approach is available only for tax-qualified variable annuities.

History

7.05 In 1959, the Supreme Court ruled that variable annuities constitute securities subject to registration with the SEC. In 1964, the U.S. Court of Appeals for the Third Circuit ruled that separate accounts funding variable annuities are investment funds that are separable from the insurance company and therefore not exempted from the 1940 Act.

7.06 Investor interest in fixed-return investments waned in the 1960s as investors' confidence in common stock as a means of combating the effects of inflation increased. Many bank trust departments assumed the duties of pension fund management and provided flexible funding arrangements, including equity investments. To meet bank competition, the life insurance industry developed variable annuities, which became increasingly popular in the late 1960s after federal legislation encouraged self-employed individuals and other professionals to establish pension accounts.

7.07 The insurance industry introduced investment annuities in the mid-1960s as a further variation of variable annuities. Investment annuities allowed individual contract holders to select their specific investment vehicles. Generally, custodian accounts were established with a third party, usually a bank, in which contract holders deposited cash or other assets. The insurer received an annual fee, usually based on a percentage of the invested assets. Though the account's assets were owned by the insurer, they were segregated for the benefit of contract holders, who directed their investments and could sell or exchange those assets at any time. Further, it was possible to fully or partially redeem investment annuities before the annuity payout period began by paying the insurer a penalty. Assets remaining in an account at the contract holder's death accrued to the insurer as a terminal premium. Investment annuities are no longer treated as annuities for federal income tax purposes.[140]

7.08 The popularity of investment and variable annuities diminished with the lackluster equity markets during the early 1970s. However, new variable annuity products were developed later in the 1970s and the early 1980s to meet the demands of the marketplace caused by increasing rates of inflation and high yields on fixed-return investment instruments. The first variable annuity wrapped around a mutual fund was developed in 1972. Such variable annuities were developed to provide both competitive investment yields and the retirement guarantees and tax deferrals inherent in annuity products.

7.09 An annuity wrapped around mutual fund shares differs from other variable annuities because a wraparound annuity is based on shares of an underlying investment vehicle, such as a mutual fund, and not on a pro rata share of individual stocks, bonds, and other investments owned by a separate account. The wraparound annuity separate account's assets typically are invested in a corporate bond fund, a common stock fund with different objectives, a liquid assets fund, or in a combination of those. The contract holder can allocate all or a portion of each payment among those investments.

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[140] Revenue Ruling *80-274*.

Product Design

7.10 A significant objective of a variable annuity contract is to provide an investment that is responsive to changes in the cost of living and that can be used to accumulate investment funds before retirement and benefits after retirement. Before retirement, the accumulated value of the individual account varies with investment performance and can be withdrawn by the contract holder in whole or in part. A contract holder may elect to receive the accumulated value of the individual account at retirement in a lump sum, in monthly payments that are fixed or variable, or in a combination of both (depending on the options available under the particular contract). If a variable benefit option is elected, the accumulated value of the contract holder's account reflects the investment performance of the securities portfolio after retirement as well as before.

7.11 The provisions of variable annuity contracts can require contract holders to make periodic payments to the sponsoring insurance company, or the contract can call for a single premium payment or provide for other methods of payment. Products typically are designed as front-end loaded or back-end loaded, as specified in the prospectus. Products with a front-end load deduct sales charges from contract holders' purchase payments, whereas back-end loaded products reduce the surrender value by contractually specified charges, if any. The net payment is used to buy accumulation units of the separate account. The value of the separate account at any time is allocated among contract holders based on the number and value of their accumulation units representing their interest in the separate account. The total value of a contract holder's accumulation units is the amount available to the contract holder at any time.

7.12 If a contract holder dies during the accumulation period, the death benefit varies, depending on the terms of the contract. The value of the death benefit is determined as of the valuation date and paid according to the applicable laws and regulations governing the payment of death benefits. If a contract holder dies after the annuity commencement date, the death benefit is the amount specified in the annuity option selected by the contract holder (it can be zero).

7.13 Typically, the insurance company charges the separate account a specified amount for investment management services (only if it is an open-ended investment company) and fees for mortality risk and administration expenses. The insurance company assumes the risk that the annuitant's mortality will be less than the rates assumed and that administration and investment expenses will not exceed the fee charged.

7.14 The insurance company assumes the mortality risk by incorporating annuity rates in the contract, which cannot be changed. Variable annuity payments are computed based on contractually specified mortality tables. The insurance company generally retains the longevity risk regardless of the method of payout the contract holder elects and must continue payments even though contract holders or their beneficiaries, depending on the payment options selected, live longer than anticipated. This is known as the mortality risk. To compensate the insurance company for assuming the mortality risk, a mortality risk premium, which is an amount usually computed daily as a percentage of the daily net asset value of the separate account, is deducted from the separate account. The insurance company may not increase the rate of that premium to existing contract holders. If the mortality risk premium is insufficient to compensate it for its costs, the loss is assumed by the insurance company. Conversely, if the mortality risk premium is greater than its costs, the excess is the insurance company's gain.

7.15 The amount of the first annuity payment of a variable annuity is determined by applying a factor in the applicable annuity table to the contract value as of the date on which annuity payments begin, in accordance with the annuity option specified in the application. The first payment is divided by the value of an annuity unit, a unit of measure used to calculate variable annuity payments, to determine subsequent variable annuity payments, and to establish the number of annuity units for each monthly payment. The number of annuity units determined on the annuity commencement date remains fixed during the annuity payment period.

7.16 The amounts of the second and subsequent payments are determined by multiplying a fixed number of annuity units by the annuity unit value on the date on which the payments are due. Thus, subsequent variable annuity payments vary in accordance with the underlying investment performance of the separate account and the resulting annuity unit value.

Reserve for Future Contract Benefits

7.17 As stated previously, a variable annuity payment option provides an annuity with payment amounts that are not predetermined, but that vary in accordance with the results of the underlying investment. The annuity period begins when amounts accumulated under the contract (the contract value) are applied under the method-of-payment option selected by the contract holder and payments begin. At each financial reporting date, the variable annuity financial statements include a reserve for future contract benefits for each contract in the payout period.

7.18 That reserve for future contract benefits, known as the annuity reserve account, is the total of an actuarial computation of the discounted amount of the expected annuity payments for each contract or group of contracts based principally on the annuity payments multiplied by the individuals' expected mortality rates on an annuity table.

7.19 The annuity reserves are calculated by multiplying the number of annuity units required for each contract, based on the contractually specified mortality table, by the annuity unit value.

SEC Registration

7.20 A separate account is established by resolution of the insurance company's board of directors in accordance with the insurance laws of the state of domicile. It is subject to policy-form approval and other requirements in each state in which the company offers the annuity. Courts have determined that variable annuities and separate accounts are subject to registration and regulation under the 1933 and 1940 Acts, respectively. The registrant is the separate account.

7.21 Initially, variable annuity issuers registered as management investment companies because they invested their assets in the open market and therefore resembled typical mutual funds in their investment objectives. The 1940 Act has a number of technical requirements for a management investment company. Among them are requirements for an elected board of directors, proxy statements, and other requirements for publicly held corporations. A separate account of a life insurance company is not a legal entity. Under state insurance laws it is owned by and forms a part of the life insurance company. Therefore, the requirements for a board of directors, proxy statements, and the like are inconsistent with the status of the separate account as part of the life insurance company. Further, a separate account cannot exist as an entity apart from the life insurance company.

7.22 Accordingly, since 1969, a number of separate accounts have registered under the 1940 Act as unit investment trusts to avoid some of the technical requirements for companies registered as management investment companies under that Act. Further, the form of a unit investment trust accommodates the need for separate accounting for the performance of specific pools of assets of group annuity contracts, personal contracts, and annuity contracts subject to different tax rules. The unit investment trust form may also accommodate lower expense charges and more flexibility in adding new products.

7.23 In 1985, the SEC adopted two registration forms for use by separate accounts offering variable annuity contracts that register under the Securities Act of 1933 and the Investment Company Act. Form N-3 is the registration form of separate accounts registered as management investment companies. Form N-4 is the registration form for unit investment trusts. Though those forms integrate and codify disclosure requirements for separate accounts and shorten the prospectus, they provide more information to investors. The auditor should become familiar with their requirements.

Auditing Considerations

7.24 Because most features of a variable annuity are similar to those of a mutual fund, the auditing guidance in other chapters of this guide applies also to variable annuities. However, there are major differences between variable annuities and mutual funds in accounting for contracts in the payout period, the calculation of the reserve for contracts in the payout period, and the taxation of insurance companies.

7.25 The mortality and interest rate assumptions are the two most significant factors in determining annuity reserves based on the annuity option selected by the contract holder, the contract holder's age at issue, and the date of issue of the annuity. The auditor should become satisfied with the variable annuity reserves by consulting published tables for the appropriate reserve factors and testing that those factors have been appropriately applied to the master file containing all outstanding contracts in the payment period. A broad outline of auditing procedures to be followed in the audit of reserves is described in the AICPA Industry Audit Guide, *Audits of Stock Life Insurance Companies.*

7.26 As previously stated, the insurance company assumes certain risks in issuing variable annuities. If the amount of the reserve is ultimately too small or too large, it does not affect the separate account but creates an amount payable to or from the insurance company. Among the factors that should be considered in examining the financial statements of a separate account funding a variable annuity is the insurance company's ability to perform if the variable annuity's assets are insufficient to meet the variable annuity's obligations.

Taxation of Annuities

7.27 Variable annuity contracts are designed for use primarily by individuals under retirement plans, which, under the provisions of the Code, may be qualified or nonqualified plans. The ultimate effect of federal income taxes on the contract value, annuity payments, and the economic benefit to the contract owner, annuitant, or beneficiary depends on the insurance company's tax status, the type of retirement plan for which the contract is purchased, and the individual's tax and employment status. The discussion in this section is general and is not intended to be an all-inclusive and comprehensive treatise on the current tax status of variable annuities.

7.28 If the annuity contract qualifies as such under the Code, a contract holder is generally not taxed on increases in the value of a contract until he receives payment in a lump sum or as an annuity under the settlement option elected. Because the variable account is a part of the operations of an insurance company, it is generally taxed as an insurance company under existing federal income tax law, not separately as a regulated investment company under subchapter M of the Code. Accordingly, under the Code, reinvested investment income is automatically applied to increase insurance company reserves under the contracts, and is not taxed. No provision for federal income taxes on investment income is required, therefore, in the variable annuity fund financial statements.

7.29 Before 1984, net realized capital gains and losses of variable annuity accounts attributable to nonqualified contracts were consolidated with the capital gains and losses of the insurance company to determine the insurance company's total amount of taxes payable. The Tax Reform Act of 1984 changed the taxation of gains or losses associated with investments of nonqualified contracts. Beginning in 1984, realized gains or losses of the separate account have not been included in the insurance company's income tax return. Instead, the related tax effects have been presented in contract holders' income tax returns on withdrawal of the funds.

7.30 In the past several years, there have been significant developments in the taxation of annuities and life insurance, some of which have affected variable annuities. When variable annuities were introduced, questions arose about whether they would be taxed under the Code in the same manner as traditional or fixed annuities. Section 801(g) was added to the Code in 1959 to exempt earnings on variable annuities. It provides that the term *annuity contract* includes variable annuities based on recognized mortality tables and the insurer's investment experience.

7.31 When the unit investment trust approach was developed using mutual funds as the underlying investment, insurers relied on several tax rulings as the basis for treating mutual fund wraparounds in a manner similar to the treatment of traditional variable annuities.

7.32 However, in April 1977, the IRS issued Revenue Ruling 77-85, which concluded that because contract holders have control over the assets and investments, they own the underlying assets and are liable for tax on their earnings. Regardless of Revenue Ruling 77-85, the IRS issued favorable letter rulings on wraparound annuities between 1977 and 1980. In Revenue Ruling 80-274, however, the IRS picked up the language of Revenue Ruling 77-85 and concluded that the position of a contract holder of an annuity wrapped around a savings account is as if the investment had been maintained or established directly with a savings and loan association. Thus, the contract holder is taxed on a current basis on the separate account income.

7.33 On September 25, 1981, the IRS issued Revenue Ruling 81-225, which held that, for federal income tax purposes, the insurance company and not the contract holder will be considered the owner of mutual fund shares underlying investments for an annuity contract, provided that such shares are unavailable to the public. Accordingly, under that ruling, if the mutual fund shares are not available to the public, the contract holder is not treated as the owner of the shares, and dividends applicable to such shares are not currently includable in the contract holder's gross income.

7.34 Section 817(h) of the Internal Revenue Code requires the investments of a separate account (or the underlying mutual fund, if the separate account is a unit investment trust) to be "adequately diversified" in accordance with Treasury regulations for annuity contracts to qualify as such under section 72 of the Code. Proposed regulations, which would be effective for years beginning after December 31, 1983, were issued in September 1986, but have not been adopted as of May 1987.

7.35 Section 72(s) of the Code provides that a contract should not be treated as an annuity for tax purposes unless it provides for certain required distributions in the event of the contract holder's death.

7.36 Section 72(q) of the Code imposes certain penalties on early withdrawals from annuity contracts.

7.37 The Tax Reform Act of 1986 also affects the taxation of annuities (including variable annuities). Tax implications on product design and the life insurance company's tax status are considerations to be reviewed each year in the audit of variable annuity financial statements.

Illustrative Financial Statements

7.38 The financial statements illustrated in this chapter are for variable annuity separate accounts registered as management investment companies. Financial statements for variable annuity separate accounts registered as unit investment trusts follow the format for unit investment trusts illustrated in chapter 6.

7.39 Certain disclosures required of registered investment companies for compliance with SEC rules and regulations are not presented in the illustrative financial statements that follow because they are not otherwise required by generally accepted accounting principles. These compliance disclosures include—

- The total cost, for federal income tax purposes, of the portfolio of investments according to rule 12-12 of Regulation S-X.
- The gross unrealized appreciation for all securities in which there is an excess of value over tax cost, and gross unrealized depreciation for all securities in which there is an excess of tax cost over value according to rule 12-12 of Regulation S-X.
- Additional disclosures required by rule 12-12 of Regulation S-X pertaining to collateral for repurchase agreements, and by rule 4-08(m) of Regulation S-X requiring certain additional disclosures if the carrying amounts of repurchase or reverse repurchase agreements exceed 10 percent of total assets or the amount at risk (as defined) under such agreements exceeds 10 percent of net asset value.
- The components of net assets presented as a separate schedule or in the notes to the financial statements according to rule 6-05.5 of Regulation S-X.

Exhibit

7.40

ABC Variable Annuity Separate Account

Statement of Assets and Liabilities

Year Ended December 31, 19X4

Assets	
Investment in common stocks at market (average cost $21,411,829) (Note 1)	$25,923,997
Total assets	25,923,997
Liabilities	
Miscellaneous	14,388
Total liabilities	14,388
Net assets	$25,909,609
Net assets attributable to variable annuity contract holders –	
12,326,506 accumulation units at $2.05 per unit	$25,232,258
Annuity reserves (Note 1)	677,351
	$25,909,609

The accompanying notes are an integral part of these financial statements.

Note: A statement of assets and liabilities in financial statements presented in accordance with generally accepted accounting principles should include a schedule of investments in securities. That schedule should follow the format illustrated in chapter 5.

Exhibit 7.41

ABC Variable Annuity Separate Account
Statement of Operations
Year Ended December 31, 19X4

Investment income		
Income		
Dividends	$ 473,865	
Interest	400,000	
Total income		$ 873,865
Expenses		
Mortality and expense risks (Notes 1 and 4)	253,022	
Investment advisory fee (Note 3)	82,097	
Total expenses		335,119
Investment income — net		538,746
Realized and unrealized gain on investments (Note 2)		
Realized net gain from securities sold	4,022,505	
Unrealized depreciation of investments	(2,660,108)	
Net gain on investments		1,362,397
Net increase in net assets resulting from operations		$1,901,143

The accompanying notes are an integral part of these financial statements.

Exhibit
7.42

ABC Variable Annuity Separate Account
Statements of Changes in Net Assets
Years Ended December 31, 19X4 and 19X3

	19X4	*19X3*
Increase (decrease) in net assets from operations		
Investment income—net	$ 538,746	$ 432,776
Realized gain on investments—net	4,022,505	3,911,023
Increase (decrease) in unrealized appreciation or depreciation—net	(2,660,108)	3,698,545
Net increase in net assets resulting from operations	1,901,143	8,042,344
Changes from principal transactions		
Purchase payments, less sales and administrative expenses and applicable premium taxes	2,841,570	2,538,803
Contract terminations	(5,458,530)	(4,465,188)
Annuity payments	(87,230)	(64,673)
Adjustments to annuity reserves (Note 1)	9,434	(21,768)
Decrease in net assets derived from principal transactions	(2,694,756)	(2,012,826)
Total increase (decrease)	(793,613)	6,029,518
Net assets		
Beginning of year	26,703,222	20,673,704
End of year	$ 25,909,609	$ 26,703,222

The accompanying notes are an integral part of these financial statements.

Exhibit

7.43

ABC Variable Annuity Separate Account

Notes to Financial Statements

1. *Significant Accounting Policies*

The ABC Variable Annuity Separate Account (the Account) is registered under the Investment Company Act of 1940, as amended, as a diversified, open-end management investment company. The Account is sold exclusively for use with retirement plans that are qualified under the Internal Revenue Code. The following is a summary of significant accounting policies consistently followed by the Account. The operations of the Account are part of ABC Life Insurance Company (the Insurance Company).

Security valuation. Investments in securities traded on a national securities exchange or exchanges are valued at their last sales prices on the principal exchange on December 31, 19X4, or if there was no reported sale during the day and for over-the-counter securities, at the last bid prices on that date.

Security transactions and related investment income. Security transactions are accounted for on the trade date (the date the order to buy or sell is executed), and dividend income is recorded on the ex-dividend date. Interest income is recorded on the accrual basis. Net investment income and net realized and unrealized gain (loss) on investments are allocated to the contracts on each valuation date based on each contract's pro rata share of the net assets of the Account as of the beginning of the valuation period.

Federal income taxes. The Account is not taxed separately because the operations of the Account are part of the total operations of the Insurance Company. The Insurance Company is taxed as a life insurance company under the Internal Revenue Code. The Account will not be taxed as a regulated investment company under subchapter M of the Code. Under existing federal income tax law, no taxes are payable on the investment income or on the capital gains of the Account.

Annuity reserves. Annuity reserves are computed for currently payable contracts according to the Progressive Annuity Mortality Table. The assumed interest rate is 3.5 percent unless the annuitant elects otherwise, in which case the rate may vary from zero to 5 percent, as regulated by the laws of the respective states. Charges to annuity reserves for mortality and expense risks experience are reimbursed to the Insurance Company if the reserves required are less than originally estimated. If additional reserves are required, the Insurance Company reimburses the variable annuity account.

2. *Purchases and Sales of Investment Securities*

The aggregate costs of purchases and proceeds from sales of investments (other than short-term securities) for the year ended December 31, 19X4, were $15,585,114 and $21,108,532, respectively. Gains and losses from sales of investments are computed on the basis of average cost.

3. *Advisory and Service Fees With Affiliates*

During the year ended December 31, 19X4, the Account incurred management fees of $82,097, payable to the Account's investment adviser, Traditional Management Company, an affiliate of the Insurance Company. The advisory agreement provides for a fee at the annual rate of 0.3066 percent of the average net assets of the Account. Deductions from purchase payments for sales and administrative expenses, which for the year ended December 31, 19X4, amounted to $162,525 and $61,361, respectively, were retained by the Insurance Company.

4. *Mortality and Expense Risks and Deductions*

Although variable annuity payments differ according to the investment performance of the Account, they are not affected by mortality or expense experience because the Insurance Company assumes the expense risk and the mortality risk under the contracts. The Insurance Company charges the Account assets for assuming those risks. For calendar year 19X4, the mortality and expense risk charges totaled $223,702.

The expense risk assumed by the Insurance Company is the risk that the deductions for sales and administrative expenses and for investment advisory services provided for in the variable annuity contract may prove insufficient to cover the cost of those terms.

The mortality risk assumed by the Insurance Company has two elements: a life annuity mortality risk and, for deferred annuity contracts, a minimum death refund risk.

The life annuity mortality risk results from a provision in the contract in which the Insurance Company agrees to make annuity payments regardless of how long a particular annuitant or other payee lives and how long all annuitants or other payees as a class live if payment options involving life contingencies are chosen. Those annuity payments are determined in accordance with annuity purchase rate provisions established at the time the contracts are issued.

Under deferred annuity contracts, the Insurance Company also assumes a minimum death refund risk by providing that there will be payable, on the death of the annuitant during the accumulation period, an amount equal to the greater of (1) the aggregate purchase payments without interest and reduced by any partial surrender, and (2) the value of the contract as of the death valuation date.

If those deductions are insufficient to cover the cost of the expense and mortality risks assumed by the Insurance Company, the Insurance Company absorbs the resulting losses and makes sufficient transfers to the fund from its general assets. Conversely, if those deductions are more than sufficient after the establishment of any contingency reserves deemed prudent or required by law, the excess is transferred to the Insurance Company.

Exhibit 7.44

Supplementary Information—Selected Per Share Data and Ratios

(Selected data for a share of accumulation unit outstanding throughout each year)

	Year ended December 31,				
	19X4	*19X3*	*19X2*	*19X1*	*19X0*
Per share data					
Investment income	$ .07	$ .05	$ .06	$ .05	$ .05
Expenses	.03	.02	.02	.01	.01
Investment income—net	.04	.03	.04	.04	.04
Net realized and unrealized gain (loss) on investments	.10	.52	.14	.06	(.11)
Net increase (decrease) in net asset value	.14	.55	.18	.10	(.07)
Beginning of year	1.91	1.36	1.18	1.08	1.15
End of year	$2.05	$1.91	$1.36	$1.18	$ 1.08
Ratios					
Ratio of operating expenses to average net assets (%)	1.26	1.26	1.26	1.26	1.26
Ratio of investment income—net to average net assets (%)	2.00	1.91	3.24	3.41	3.05

Note: See paragraph 5.40 for a discussion of additional information that may be included in this schedule. Also, see item 4 of SEC Registration Form N-4 for the required condensed financial information that must be included in the prospectus.

Chapter 8

Other Accounts and Considerations

8.01 This chapter presents matters not discussed elsewhere in this guide.

Investment Advisory (Management) Fee

8.02 As discussed in chapter 1, an investment adviser is usually engaged by an investment company and is paid a fee, which generally is the largest expense incurred by the company. It is usually reflected in the daily net asset value calculation at rates established by the investment advisory agreement. Certain agreements may provide for performance fee adjustments based on a comparison of the companies' performances against indexes specified in the agreements.[141]

8.03 The amount of a performance fee recorded at an interim date should be based on performance to date. However, according to the SEC's policy, interim payments to the adviser should be based on the minimum fee provided in the agreement, because if performance for the year yields a fee that is lower than the interim payments, an excess may represent a loan to the adviser. Performance fees based on a rolling or moving period are discussed in Release No. 7113 of the 1940 Act.

8.04 The securities laws of certain states in which the investment company's securities are sold may impose limitations on certain investment company expenses. The usual agreement requires the investment adviser to reimburse the company for certain expenses that exceed a specified percentage of the average net assets during the year. To determine whether an expense reimbursement receivable should be accrued at an interim date, estimated expenses and sales and redemptions of fund shares for the remainder of the year should be considered. In the absence of strong evidence to the contrary about estimated sales and redemptions of fund shares, it may be assumed that average net assets will remain constant. The independent auditor should review the calculations for agreement with the provisions of the investment advisory contract.

Expenses

8.05 The investment company's expenses should be reviewed for compliance with the provisions of the investment advisory contract, the prospectus, and other relevant agreements. (See paragraph 5.29.)

Cash

8.06 The auditor should become satisfied that the applicable recordkeeping requirements of the 1940 Act are being met.[142] Procedures to test cash are similar to those used to audit the financial statements of other business enterprises. They should be applied to cash on hand or in noncustodial accounts and to other funds subject to withdrawal restrictions.[143] A special report to the board of directors is required by SEC Release No. 7164 of the 1940 Act if the auditor finds inadequacies in the internal controls for petty cash.

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[141] SEC Release No. 7113 of the 1940 Act.

[142] Rules 31a-1, 31a-2, and 31a-3 of the 1940 Act.

[143] SEC Releases 6863, 7107, and 7164 under the 1940 Act.

Minutes

8.07 In reviewing the board of directors' minutes, the auditor should note such significant items as dividend declarations and amendments to and continuation of contracts and agreements with such entities as the adviser, the transfer agent, the custodian, and the underwriter.

Expenses During the Development Stage

8.08 The provisions of FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*, apply to financial statements issued by investment companies in the development stage, as defined in that Statement.

8.09 A newly formed investment company incurs organization expenses unless it is sponsored by a management company that has agreed to absorb such expenses. Organization expenses consist of expenses incurred to establish the company and legally equip it to engage in business.

8.10 An open-end investment company, organized to offer shares of capital stock to the public continuously and to invest the proceeds from the sale of such capital stock, should not be considered organized until it has registered securities with the SEC. Therefore, expenses incurred by a newly organized open-end investment company to prepare its initial registration statement and to obtain its SEC clearance should be accounted for as organization expenses; expenses incurred after the registration statement has been declared effective by the SEC, such as printing prospectuses for sales purposes, are not usually considered organization expenses. Organization expenses of investment companies are usually deferred and amortized. The SEC requires all organization expenses expected to be incurred by the fund to be presented as a liability in the investment company's financial statements, which are included in the initial registration statement.

8.11 Once an investment company has been organized to do business, it usually engages immediately in its planned principal operations, that is, the sale of capital stock and investment of funds. Employee training, development of markets for the sale of capital stock, and similar activities are usually performed by the investment adviser or other agent, and their costs are not borne directly by the investment company. However, an investment company, particularly one not engaging an agent to manage its portfolio and to perform other essential functions, may engage in such activities for a time and may bear those costs directly during its development stage.

8.12 Paragraph 10 of FASB Statement No. 7 notes that "generally accepted accounting principles that apply to established operating enterprises . . . shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred." Therefore, the costs discussed in the preceding paragraph are deemed not to be organization expenses and should be accounted for in accordance with generally accepted accounting principles for established operating enterprises.

8.13 Recurring registration fees and expenses of open-end companies are charged to expense. Closed-end companies charge all registration fees against paid-in capital at the time shares are sold.

Amortization of Deferred Costs

8.14 Costs deferred by an investment company should be subject to the assessment of recoverability applicable to an established operating company. Such costs should be amortized to income over the period that a benefit is expected to be realized. That period may vary by the type of expense.

8.15 The investment company's accounting policies for deferred costs should be disclosed in the notes to the financial statements.

Organization Expenses

8.16 Organization expenses generally are amortized over the period of benefit, but not over more than sixty months from the date operations began. The straight-line method should be applied unless the company demonstrates that another systematic and rational method is more appropriate.

8.17 If the amortization of such expenses is based on assets expected to be managed over the period selected, the estimated growth rate initially used to establish an amortization table should be reviewed frequently and adjusted, if necessary, to reflect experience.

Costs of Printing Prospectuses

8.18 Costs of printing prospectuses for sales purposes, if paid by the fund, are generally deferred and amortized on a straight-line basis over the period during which the prospectus may be used. If it becomes evident during that period that the prospectus will be effective for a shorter period than originally anticipated, the adjustment should be accounted for prospectively as a change in estimate.

Registration Fees

8.19 Deferred SEC and state registration fees should be amortized as registered shares of stock are sold over sixty months or less.

Unusual Income Items

8.20 Unusual income items, such as amounts recovered from the settlement of litigation, are usually recognized in the financial statements when the company acquires an enforceable right. Before an unusual item is collected, it should be valued by the board of directors, and subsequent changes in its value should be recorded. The item and a subsequent revaluation should be presented as other income, if any, or as a separate income item. If the item is sufficiently material in relation to net investment income, it should be presented as a line item immediately before net investment income, unless the item is clearly identifiable with realized or unrealized gains or losses. The tax ramifications of such unusual credits are discussed in chapter 4.

Provision for Taxes

8.21 Provisions for taxes by investment companies are usually presented under the separate income categories (that is, investment income and realized and unrealized gains) to which they apply. However, if the company, such as a tax-managed fund, does not meet the requirements necessary to be taxed as a regulated investment company, such provisions for taxes should be presented in the statement of operations in total as a deduction from income before taxes, that is, similar to the usual presentation for other taxable entities. A provision for deferred income taxes, if any, should be presented separately. If a liability for taxes on accumulated earnings is recorded in accordance with FASB Statement No. 5, *Accounting for Contingencies,* it should be similarly disclosed. An allocation of taxes to income categories is not relevant for such companies, because, unlike investment companies, which act as tax conduits, companies that do not qualify to be taxed as regulated investment companies do not pass through to shareholders investment income or realized gains. Because the entity is taxed at the corporate level, shareholders incur capital gains or losses only on redemption of shares, regardless of the nature of the income earned by the company during the period of ownership.

Form N-SAR

8.22 Form N-SAR is the semiannual and annual report filed with the SEC by all registered management investment companies, small business investment companies, and unit investment trusts.

8.23 Form N-SAR, effective April 30, 1985, contains numerous items and must be filed with the SEC within sixty days of the end of the semiannual or annual reporting period, as applicable. Unit investment trusts are required to file annual reports only. The company's independent auditors are not required to audit and report on items contained in Form N-SAR.

8.24 Form N-SAR requires a management investment company to provide a report of its independent public accountant on the company's system of internal accounting controls. Form N-SAR states that the report should be "based on a review, study, and evaluation of the accounting system, the system of internal accounting control, and procedures for safeguarding securities made during the audit of the financial statements. The report should disclose material weaknesses in the accounting system, the system of internal accounting control procedures for safeguarding securities that exist as of the end of the registrant's fiscal year. Disclosure of a material weakness should include an indication of any corrective action taken or proposed." The accountant's report should be presented as an exhibit to the form (N-SAR) filed for the company's fiscal year and should be addressed to the company's shareholders and board of directors, dated, and signed manually. It should also indicate the city and state where issued. An illustrative report is presented in chapter 9.

8.25 The SEC has indicated that it will not regard the fact that the accountant's report is attached to Form N-SAR as acknowledgment that the form has been reviewed by the accountant.

8.26 Small business investment companies or other investment companies not required by either the Investment Company Act or other federal or state laws, or rules or regulations thereunder, to have audits of their financial statements are exempt from the provisions regarding auditors' letters on internal accounting control.

Business Combinations

8.27 Investment companies that combine normally combine in tax-free reorganizations. In such reorganizations, shares of one company are exchanged for substantially all the shares or assets of another. The primary purpose of such combinations is to reduce operating costs and improve performance by minimizing certain fixed costs over a large asset base. The composition of the acquired investment company's portfolio usually is less important to the acquiror than the overall size of the acquired pool of assets. One of the combining companies usually is clearly the survivor, retaining its name and investment objectives. Following a combination, portfolios of investment companies often are realigned to fit the objectives, strategies, and goals of the surviving company. It is generally unnecessary to adjust the carrying values of assets or liabilities to determine exchange formulas, because the net assets of investment companies are stated at value for financial reporting purposes.

8.28 Tax-free business combinations of investment companies are accounted for by a method that most closely approximates the accounting followed for tax purposes. Companies combined in a nontaxable exchange of shares should carry forward the historical cost basis of investment securities to the surviving entity and should not restate the results of operations for precombination periods. The amount of unrealized appreciation or depreciation and the amount of undistributed investment company income, if significant, should be disclosed separately to report meaningful information about the fund's performance.

8.29 The statement of operations, the statement of changes in net assets, and the schedule of selected per share data are not restated.

8.30 If the combination is a taxable reorganization, the provisions of APB Opinion No. 16, *Business Combinations*, should be followed, including its disclosure requirements. The essential difference between the purchase method and that used for tax-free business combinations is that under the purchase method the cost basis of the assets acquired is restated to value on the date of the combination.

8.31 Disclosures for all business combinations should include a summary of the essential elements of the combination, that is, the effective date, the number and value of shares issued by the surviving company, the exchange ratio, the tax status, and tax attributes. The separate and combined aggregate net assets should be presented as of the date of combination. (See appendix E, "Illustrative Financial Statement Presentation for Tax-Free Business Combinations of Investment Companies.")

Diversification of Assets

8.32 An investment company may use a worksheet such as the one in appendix C to determine and document that it has complied with the diversification requirements stated in its registration statement. The auditor should consider reviewing that worksheet to become satisfied about the fund's representations of the diversification of its assets.

8.33 Those diversification requirements differ from the requirements under subchapter M, discussed in chapter 4.

Equity Method

8.34 Investment companies are exempt from applying APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, to their portfolio securities because they account for them at value. Such companies do not normally consolidate their financial statements, except for ownership in another investment company. However, investments in assets that provide facilities or services to the investment company for long-term operating purposes should ordinarily be carried on the equity basis in accordance with APB Opinion No. 18.

Distribution Expenses

8.35 Rule 270.12b-1 of the 1940 Act permits an investment company, in compliance with specified conditions, to pay for costs incurred to distribute its shares. Payments are made pursuant to a plan, commonly known as a "12b-1 plan," adopted by the board of directors. There are many forms of such plans, and the auditor should review their provisions. Distribution expenses paid with an investment company's assets are accounted for as operating expenses.[144]

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[144] Rule 6-07.2(f) of Regulation S-X.

Chapter 9

Independent Auditor's Reports

9.01 The auditor's report on the audit of a management investment company's financial statements states specifically that securities have been confirmed or physically examined to substantiate their existence.[145] That statement is made because of the high relative importance of investments in securities to the business of an investment company. It is customary (required for registered investment companies) to address the auditor's report to the company's shareholders and its board of directors.[146]

9.02 The following auditor's reports on financial statements illustrate pertinent items discussed in the guide, but do not cover all the diverse circumstances that may occur in practice. It is essential, therefore, that the auditor modify the reports according to the requirements of the particular circumstances.

Reports on Financial Statements

9.03 The following form of auditor's report may be used to express an unqualified opinion on the financial statements:

Independent Auditor's Report

To the Shareholders and
Board of Directors:
XYZ Investment Company

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company, including the schedule of portfolio investments, as of December 31, 19X4, and the related statements of operations and cash flows[147] for the year then ended, the statement of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 19X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 19X4, the results of its operations and its cash flows[148] for the year then ended, the changes in

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[145] SEC, *Codification of Financial Reporting Policies,* section 404.03.a.

[146] Section 32(a) of the 1940 Act.

[147] FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Held for Resale,* amends FASB Statement No. 95, *Statement of Cash Flows,* to exempt highly liquid companies that meet specified conditions from the requirement to provide a statement of cash flows.

[148] See footnote 147.

its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

Independent Auditor

Anytown, USA
January 21, 19X5

9.04 The reference to "and brokers" in the fourth sentence of the scope paragraph is not normally required if the investment company's financial statements do not show an amount payable for securities purchased. Also, if securities were "verified by examination," the report should be modified to state that.

9.05 The accountant's report for a fund referred to as a "series fund" needs to be modified because of the uniqueness of the financial statements that have evolved to present its financial position, results of operations, and cash flows. The financial position, results of operations, and cash flows of the portfolios or other entities constituting the series are frequently presented in separate columns. The financial statements of the series may also be presented as if the series were a separate entity. In both cases, the scope of the audit should be sufficient to enable the auditor to report on the individual financial statements of the various entities constituting the series fund.

9.06 The following illustration is for a multicolumnar presentation of the portfolios constituting the series:

Independent Auditor's Report

To the Shareholders and
Board of Directors
XYZ Series Investment Company:

We have audited the statements of assets and liabilities, including the schedules of investments, of XYZ Series Investment Company (comprising, respectively, the Foreign, Domestic Common Stock, Long-Term Bond, and Convertible Preferred Portfolios) as of December 31, 19X4, and the related statements of operations and cash flows[149] for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

[*Same second paragraph as in the report illustrated in paragraph 9.03*]

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of each of the respective portfolios constituting the XYZ Series Investment Company as of December 31, 19X4, the results of their operations and their cash flows[150] for the year then ended, the changes in their net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

Independent Auditor

Anytown, USA
January 21, 19X5

9.07 The following illustration is for a presentation of one of the portfolios or entities constituting the series:

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[149] See footnote 147.
[150] See footnote 147.

Independent Auditor's Report

To the Shareholders and
Board of Directors
XYZ Series Investment Company:

We have audited the accompanying statement of assets and liabilities, including the schedule of portfolio investments, of the Convertible Preferred Portfolio (one of the portfolios constituting the XYZ Series Investment Company) as of December 31, 19X4, and the related statements of operations and cash flows[151] for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

[*Same second paragraph as in the report illustrated in paragraph 9.03.*]

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of the Convertible Preferred Portfolio of the XYZ Series Investment Company as of December 31, 19X4, and the results of its operations and cash flows[152] for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

Independent Auditor

Anytown, USA
January 21, 19X5

The auditor's reports illustrated in this paragraph and in paragraph 9.06 are not intended to be all-encompassing or necessarily illustrative of all situations that may be encountered in practice.

9.08 The auditor's report should include an explanatory paragraph when the financial statements contain securities whose values were estimated by the board of directors in the absence of readily ascertainable market values, and the range of possible values of those securities is significant. That report, as illustrated below, should be used only if the auditor concludes that, after examining the underlying documentation supporting the board's good-faith estimate of value, the valuation principles are acceptable, are being consistently applied, are reasonably supported by the documentation, and the range of possible values is significant. If the range of possible values is not significant, a report such as that illustrated in paragraph 9.03 may be issued.

Independent Auditor's Report

To the Shareholders and
Board of Directors
XYZ Investment Company:

[*Same first, second, and third paragraphs as in the report illustrated in paragraph 9.03.*]

As explained in Note 2, the financial statements include securities valued at $______ (______ % of net assets), whose values have been estimated by the Board of Directors in the absence of readily ascertainable market values. We have reviewed the procedures used by the Board of Directors in arriving at its estimate of value of such securities and have inspected underlying

[151] See footnote 147.
[152] See footnote 147.

documentation, and, in the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, those estimated values may differ significantly from the values that would have been used had a ready market for the securities existed, and the differences could be material.

Independent Auditor

Anytown, USA
January 21, 19X5

9.09 If the auditor concludes that the valuation procedures are inadequate or unreasonable, or that the underlying documentation does not support the valuation, the auditor should express a qualified opinion as follows:

Independent Auditor's Report

To the Shareholders and
Board of Directors
XYZ Investment Company:

[*Same first and second paragraphs as in the report illustrated in paragraph 9.03.*]

As explained in Note 2, the financial statements include securities valued at $________ (________ % of net assets), whose values have been estimated by the Board of Directors in the absence of readily ascertainable market values. We have reviewed the procedures used by the Board of Directors in arriving at its estimate of value of such securities and have inspected underlying documentation. In our opinion, those procedures are not reasonable, and the documentation is not appropriate to determine the value of the securities in conformity with generally accepted accounting principles. The effect on the financial statements of not applying adequate valuation procedures is not readily determinable.

In our opinion, except for the effects on the financial statements and selected per share data and ratios of the valuation of investment securities determined by the Board of Directors, as described in the preceding paragraph, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 19X4, the results of its operations and its cash flows[153] for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

Independent Auditor

Anytown, USA
January 21, 19X5

Report on Examination of Securities Pursuant to Rules Under the 1940 Act

9.10 The following form of report is used for each examination of securities mandated under rules 17f-1 and -2 of the 1940 Act.

To the Board of Directors of
XYZ Management Investment Company:

We have examined the investment accounts shown by the books and records of XYZ Management Investment Company for the period from the date of our last similar examination on April 28, 19X4, to August 17, 19X4. Our examination was made without prior notice to the Company.[154] It is under-

[153] See footnote 147.

[154] The phrase "without prior notice to the Company" should be deleted if the examination was not performed on a surprise basis.

stood that this report is solely for the use of management and the Securities and Exchange Commission and should not be used for any other purpose.

Securities owned as of the close of business on August 17, 19X4, shown by the books and records audited by us, which we counted and inspected, were located in the vault of [*name and address*], except for securities purchased but not received, pledged, or out for transfer on that date, as to which we obtained confirmation from the brokers, pledgees, and transfer agents, respectively.

Because the above procedures do not constitute an audit in accordance with generally accepted auditing standards, we do not express an opinion on the investment accounts referred to above. In connection with the procedures referred to above, no matters came to our attention that caused us to believe that the specified accounts should be adjusted. Had we performed additional procedures or had we audited the financial statements in accordance with generally accepted auditing standards, matters might have come to our attention that would have been reported to you. This report relates only to the investments specified above and does not extend to any financial statements of XYZ Investment Company, Inc., taken as a whole.

Independent Auditor

Anytown, USA
September 23, 19X4

Report on Internal Control Required by the SEC

9.11 The following is an illustration of the independent auditor's report on a management investment company's internal control structure based on the results of procedures performed in obtaining an understanding of the internal control structure and assessing control risk. These procedures should include the review, study, and evaluation of the accounting system, internal accounting controls, and procedures for safeguarding securities required by the instructions to Form N-SAR.

Board of Directors
XYZ Investment Company

In planning and performing our audit of the financial statements of XYZ Investment Company for the year ended December 31, 19X1, we considered its internal control structure, including procedures for safeguarding securities, in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and to comply with the requirements of Form N-SAR, not to provide assurance on the internal control structure.

The management of XYZ Investment Company is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. Two of the objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and transactions are executed in accordance with management's authorization and recorded properly to permit preparation of financial statements in conformity with generally accepted accounting principles.

Because of inherent limitations in any internal control structure, errors or irregularities may occur and may not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that it may become inadequate because of changes in conditions or that the effectiveness of the design and operation may deteriorate.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control structure, including procedures for safeguarding securities, that we consider to be material weaknesses as defined above as of December 31, 19X1.[155]

This report is intended solely for the information and use of management and the Securities and Exchange Commission.

Accounting Firm
New York, New York
February 15, 19X2

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[155] If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of the fourth paragraph of the report should be modified as follows:

> However, we noted the following matters involving the (control environment, accounting system, control procedures, or procedures for safeguarding securities) and its (their) operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the financial statements of XYZ Investment Company for the year ended December 31, 19X1, and this report does not affect our report thereon dated February 15, 19X2. [*A description of the material weaknesses that have come to the auditor's attention would follow. Also, Sub-item 77B of the instructions to Form N-SAR says "(d)isclosure of a material weakness should include an indication of any corrective action taken or proposed."*]

Appendix A

Venture Capital and Small Business Investment Companies

Venture capital investment companies, including most small business investment companies, and business development companies differ in operating method from other types of investment companies. The usual open-end or closed-end company is a passive investor, whereas the venture capital investment company is more actively involved with its investees. In addition to providing funds, whether in the form of loans or equity, the venture capital investment company often provides technical and management assistance to its investees as needed and requested.

The portfolio of a venture capital investment company may be illiquid by the very nature of the investments, which are usually securities with no public market. Often, gains on those investments are realized over a relatively long holding period. The nature of the investments therefore requires valuation procedures that differ markedly from those used by the typical investment company with which this guide primarily deals.

Venture capital investment companies may incur liabilities not generally found in other investment companies. Leverage opportunities available to the owners of those companies are not available to open-end companies and are not often found in closed-end companies. SBICs, by statute, may borrow from the Small Business Administration (SBA), often at advantageous rates, up to two or three times their paid-in capital.

Though all venture capital investment companies should prepare their financial statements in conformity with generally accepted accounting principles and are subject to audit as are other investment companies, the statement presentation of some companies may need to be tailored to present the information in a manner most meaningful to their particular group of investors. For example, if debt is a significant item, a balance sheet might be more appropriate than a statement of net assets. Also, different regulatory procedures may apply. Publicly owned SBICs are subject to the provisions of Article 5 of Regulation S-X, whereas other publicly owned venture capital investment companies are subject to Article 6.

The unique features (primarily the existence of significant debt) of SBICs often make it desirable that their financial statements be presented in a conventional balance sheet format. SBICs are regulated by the SBA and accordingly are required to comply with part 107 of the SBA rules and regulations. Appendixes I and II of part 107 deal with specific aspects of SBA regulation, such as the specific audit procedures and reporting requirements (for example, on Form 468) of the SBA for small business investment companies, the system of account classification, and guidance on proper techniques and standards to be followed in valuing portfolios. The auditor of an SBIC should be familiar with those publications and aware of changes in SBA regulations.

The format for reporting the results of SBIC operations varies from that presented in this guide for other types of investment companies.

Appendix B

Computation of Taxable Amortization of Bond Discount

Table 1
Taxable Corporate Obligations

		Reporting of Amortization		*Reporting of Amortization as*	
	Method of Amortization	*On a Daily Basis*	*At Disposition*	*Capital Gain*	*Interest Income*
Short-term obligations *					
Original issue discount	SL †	X			X
Market discount	NA	† ‡	X		X
Long-term obligations					
Original issue discount					
Issued 12/31/54—5/26/69	SL		X		X
Issued 5/27/69—7/1/82	SL	X			X
Issued 7/2/82—7/18/84	YTM	X §			X
Issued after 7/18/84	YTM	X §			X
Market discount					
Issued after 7/18/84 §	SL †	‡	X		X ″
Issued before 7/19/84	NA		X	X	

SL = straight line (ratable); YTM = yield to maturity; NA = not applicable.

* Short-term is defined as having a maturity of not more than one year after date of issue.

† The straight-line method is required unless the yield-to-maturity method is elected (Rule 1283(b)(2) for short-term obligations and Rule 1276(b)(2) for long-term obligations).

‡ An election may be made to report amortization currently as interest. The election would apply to all market discount bonds acquired after the first day of the taxable year in which the election is made (Rule 1283(c)(2) for short-term obligations and Rule 1278(b) for long-term obligations).

§ Accrual period with respect to which OID is computed and compounded is a one-year period for obligations issued before 1/1/85 and is each six-month period for obligations issued after 12/31/84.

″ Amortization is treated as interest income to the extent of accrued market discount when there is a gain on disposition (Rule 1276(a)).

Table 2
Taxable Government Obligations

	Method of Amortization	Reporting of Amortization: On a Daily Basis	Reporting of Amortization: At Disposition	Reporting of Amortization as: Capital Gain	Reporting of Amortization as: Interest Income
Short-term obligations*					
Acquisition discount †					
Acquired after 7/18/84	SL ‡	X			X §
Long-term obligations					
Original issue discount					
Issued 12/31/54—7/1/82	SL		X		X
Issued 7/2/82—7/18/84	YTM	X ‖			X
Issued after 7/18/84	YTM	X ‖			X
Market discount					
Issued before 7/19/84	NA		X	X	
Issued after 7/18/84	SL ‡	#	X		X **

SL = straight line (ratable); YTM = yield to maturity; NA = not applicable.

* Short-term is defined as having a maturity of not more than one year after date of issue.

† An acquisition discount represents an excess of the stated redemption price over basis. It applies to short-term obligations only.

‡ The straight-line method is required unless the yield-to-maturity method is elected (section 1276(b)(2)).

§ Revenue Ruling 75-376 indicates that under the rules before the Tax Equity and Fiscal Responsibility Act of 1982, the discount on short-term government obligations would constitute interest income.

‖ Accrual period for compounding is one year for obligations issued before 1/1/85 and semiannual periods for obligations issued after 12/31/84.

\# An election may be made to report amortization currently (section 1278(b)). The election would apply to all market discount bonds acquired after the first day of the taxable year.

** Amortization is treated as interest income when there is a gain on disposition to the extent of accrued market discount (section 1276(a)).

Table 3
Tax-Exempt Obligations

	Method of Amortization	*Reporting of Amortization: On a Daily Basis*	*Reporting of Amortization: At Disposition*	*Reporting of Amortization as Tax-Exempt Interest Income*
Issued after 9/3/82 and acquired after 3/1/84				
Original issue discount				
Short-term obligations †	SL *		X *	X
Long-term obligations	YTM	X		X
Market discount				
Short-term obligations †	NA			
Long-term obligations	NA			
All other acquisitions				
Original issue discount				
Short-term obligations †	SL		X	X
Long-term obligations	SL		X	X
Market discount	NA			

SL = straight line (ratable); YTM = yield to maturity; NA = not applicable.

* May elect to accrue daily on a yield-to-maturity method (section 1288(b)(3) and 1283(b)).

† Short-term is defined as having a maturity of not more than one year after the date of issue.

Appendix C

Internal Revenue Code Worksheets *

I. Code Section 851 requirements:
Assets (as of close of each quarter):

A	Cash, receivables, securities, and total other assets		$ ______
B-1	Cash, receivables, government securities, and securities of other regulated investment companies	$ ______	
B-2	Other securities not including either (*a*) securities of any one issuer having a value in excess of 5 percent of line A or (*b*) securities representing more than 10 percent of the outstanding voting securities of any one issuer. (Exclude entire amount of investments that exceed either limitation.)	______	
B-3	(Lines B-1 plus B-2)		$ ______
C	25 percent of line A		$ ______
	Line B-3 must be at least 50 percent of line A		

No one issue (other than government securities or securities of other regulated investment companies) can exceed line C.

Income (for the taxable year to date **):

	Net gain on securities sold (tax basis)	$ ______
	Add	
	Capital losses on sales of securities	______
	Interest and dividends from investments	______
	Income from securities on loan	______
	Other income	______
D	Total	$ ______
E	10 percent of line D	$ ______
F	30 percent of line D	$ ______

Other income cannot exceed line E
Gains on securities held less than three months must be less than line F

II. Eligibility of company's ordinary income dividends for the 80 percent dividend-received deduction for corporations:

* These worksheets will be updated to conform to current Internal Revenue Code in a future update.

** This computation should be done by the company at least monthly so that failure to meet the requirements can be determined and corrected on a current basis.

A	Gross income †	$ ______
B	Dividends from qualifying domestic corporations	$ ______

If line B is less than line A, the company must advise corporate shareholders of the applicable portion eligible for the 80 percent dividend-received deduction.

III. Test of dividend-paid deduction and federal income tax status

		Year Ended
	Ordinary Income	
1.	Net income (exclusive of equalization)	______
	Adjustments—	
2.	Dividend receivable, beginning	______
3.	Dividend receivable, ending	(______)
4.	Nontaxable cash dividends received	(______)
5.	State tax on net securities gains	(______)
6.	Other	(______)
7.	Total	______
	Add—	
8.	Net short-term capital gains in excess of net long-term capital losses	______
9.	Net investment (taxable) income	______
	Deduct—	
	Dividend payments in—	
10.	Current year, total	______
11.	Current year, related back to prior year	(______)
12.	Subsequent year, to be related back to current year	______
13.	Gross equalization debits (optional)	______
14.	Total	______
15.	Subchapter M net income (loss) (item 9 less item 14)	______
16.	10% of net investment income (item 9)	______
17.	Excess of 15 over 16 (excess means a disqualification)	______
	Securities Profits (or Losses)—Tax Basis	
18.	Net long-term gain (loss)	______
19.	Net short-term gain (loss)	______
20.	Nontaxable cash dividends treated as gains	______
21.	Other	______
22.	Total	______
	Deduct—	
23.	Carryforward loss of Fund	______
24.	Carryforward loss acquired by merger	______
25.	Total	______
26.	Net gain (loss)	______
	Deduct—	
	Distributions paid in—	
27.	Current year, total	______
28.	Current year, related back to prior year	(______)
29.	Subsequent year, to be related back to	

† Ordinary income plus excess of net short-term capital gains over net long-term capital losses.

current year __________
30. Net short-term gains included in ordinary income __________
31. Total __________
32. Remainder of taxable gains __________

Appendix D

Worksheet for Diversified Management Investment Companies (As Defined in Section 5(b)(1) of the Investment Company Act)

A. Definitions and requirements (references are to the 1940 Act and rules thereunder):

1. *Diversified company*—A management investment company is diversified if at least 75 percent of the *value* of the company's *total assets* is represented by all of the following:
   - (a) Cash and cash items (including receivables)
   - (b) U.S. government securities
   - (c) Securities of other investment companies
   - (d) Other securities limited for any one issuer to not more than 5 percent of the *value* of the company's *total assets* and to not more than 10 percent of the outstanding voting securities of such issuer (section 5(b)).[156] (Exclude the entire amounts of investments that exceed either limitation.)

     A company does not lose its classification as diversified if the percentage requirements are not met solely because of post-acquisition changes in security prices (section 5(c)).

     The portfolio requirements apply only to 75 percent of the value of the company's total assets. The remaining 25 percent need not be diversified and may be invested in the securities of a single issuer.
2. *Value,* as used in section 5—
   - (a) With respect to securities owned at the end of the preceding fiscal quarter, is the market value at the end of such quarter.
   - (b) With respect to securities and other assets acquired after the end of the preceding fiscal quarter, is the cost thereof (section 2(a)(41)).
3. *Total assets* as used in section 5 shall mean the gross assets of the company with respect to which the computation is made, taken as of the end of the company's fiscal quarter preceding the date of computation (rule 5b-1).

B. Determine those portfolio securities that exceed 5 percent of the value of total assets at the end of each fiscal quarter.

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[156] Special consideration should be given to the designation of the issues for the investments in options, futures, and securities guaranteed by parties other than the named issuer or backed by letters of credit.

Note: For Internal Revenue Code purposes, the diversification worksheet is contained in appendix C.

	Quarter			
	1st	*2d*	*3d*	*4th*
1. Total assets	$	$	$	$
2. 5 percent of total assets	$	$	$	$

3. Portfolio securities at value in excess of line 2 above:

	Quarter-End Value			
	1st	*2d*	*3d*	*4th*
Security name	$	$	$	$

C. If any of the securities named in line 3 above were purchased during the quarter under review, it must be determined if that acquisition caused an investment of more than 5 percent of the company's total assets as follows:

Determination of total assets at acquisition date:

1. Total assets at quarter-end prior to acquisition date.

Determination of value and percent of total assets of security acquired:

2. Value of security at prior quarter-end.
3. *Add*—Purchases of security at cost including latest acquisition.
4. *Deduct*—Sales of security at prior quarter-end value.
5. Value of security acquired (line 2 plus line 3 less line 4).
6. Percent of value of security acquired to total assets (line 5 divided by line 1).

D. Determination of issuers in which more than 10 percent of outstanding voting securities is owned:

1. Determine if the company owns more than 10 percent of any issuer's outstanding voting securities by referencing to current published material or other sources; include conversion of securities convertible into voting securities.
2. Determine the percentage of value of company total assets invested in such issuers at each quarter-end.

E. Total the percentages for each security acquired that exceeds 5 percent as computed in line 6 or for each security in which the company's investment constitutes more than 10 percent of the issuer's outstanding voting securities as computed in D-2 above. Total the percentages. If the sum is 25 percent or less, the company meets the requirements of a diversified company under section 5(b) of the 1940 Act. If the total is more than 25 percent at any time, no further investments may be made in the securities constituting the 25 percent, nor in other issues if that investment would amount to more than 5 percent of the value of the total assets or more than 10 percent of the outstanding voting securities of the issuer.

Note: Because of requirements of some state Blue Sky laws, many diversified investment companies are subject to investment restrictions, as stated in their 1940 Act and 1933 Act registration statement, which are more confining than the restrictions stated in section 5(b)(1) of the 1940 Act and applied in the above worksheet. In many of those cases, not more than 5 percent of the companies' assets, at the time of each purchase, may be invested in the securities of any one issuer other than the U.S. government. In testing compliance with those investment restrictions, all valuations are determined as of the time of each proposed transaction to which section 2(a)(41) and rule 5b-1 of the 1940 Act, described in items A-2 and A-3 above, are not applicable. In determining the value of the total assets at the time, it is sufficient to use the computation as of the close of the previous day, with some allowance for large market price changes during the current trading day.

Appendix E

Illustrative Financial Statement Presentation for Tax-Free Business Combinations of Investment Companies

The following financial statements and disclosures illustrate a tax-free business combination of an investment company (discussed in chapter 8). The illustrative footnotes are unique to a business combination. The exhibits assume that Fund B merges into Fund A as of the close of business on December 31, 19X4. Exhibit 1 presents the financial position, results of operations, and changes in net assets of each fund immediately before the acquisition. Exhibits 2 and 3 present the financial statements and appropriate notes of the combined entity immediately after the acquisition, joining net assets and historical costs of investments in securities. The individual components of net assets (capital paid in, undistributed income and capital gains, and unrealized appreciation and depreciation) are similarly combined. The results of operations, changes in net assets, and the schedule of selected per share data and ratios (not illustrated) are not restated.

Exhibit 1

Financial Position, Results of Operations, and Changes in Net Assets of Each Fund Immediately Before Acquisition

Statement of Net Assets

December 31, 19X4

	Fund A	*Fund B*
Investments in securities, at value (Cost: Fund A — $18,000,000 Fund B — $9,000,000)	$20,000,000	$10,000,000
Other assets	1,000,000	500,000
	21,000,000	10,500,000
Liabilities	1,000,000	500,000
Net assets	$20,000,000	$10,000,000
Shares outstanding	2,000,000	1,000,000
Net asset value per share	$ 10.00	$ 10.00

Statement of Operations—

Year Ended December 31, 19X4

Dividend and interest income	$ 3,200,000	$ 1,600,000
Management fee	100,000	50,000
Transfer agent's fee	50,000	25,000
Other expenses	50,000	25,000
	200,000	100,000
Investment income — net	3,000,000	1,500,000
Realized and unrealized gain on investments		
Net realized gain from investments	1,000,000	500,000
Change in unrealized appreciation for the year	1,000,000	500,000
Net gain on investments	2,000,000	1,000,000
Net increase in net assets resulting from operations	$ 5,000,000	$ 2,500,000

Statement of Changes in Net Assets—
Year Ended December 31, 19X4

	Fund A	*Fund B*
Increase (decrease) in net assets		
Operations		
Investment income — net	$ 3,000,000	$ 1,500,000
Net realized gain from investments	1,000,000	500,000
Change in unrealized appreciation	1,000,000	500,000
	5,000,000	2,500,000
Dividends to shareholders from —		
Investment income — net	(3,000,000)	(1,500,000)
Net realized gain from investments	(1,000,000)	(500,000)
Capital shares transactions	2,000,000	250,000
Total increase	3,000,000	750,000
Net assets		
Beginning of year	17,000,000	9,250,000
End of year	$20,000,000	$10,000,000

Exhibit 2

Financial Statements of the Combined Entity

Immediately After Acquisition

Statement of Net Assets

December 31, 19X4

Investments in securities, at value	
Identified cost — $27,000,000	$30,000,000
Other assets	1,500,000
	31,500,000
Liabilities	1,500,000
Net assets	$30,000,000
Shares outstanding	3,000,000
Net asset value per share	$ 10.00

Statement of Operations—

Year Ended December 31, 19X4

Dividend and interest income		$ 3,200,000
Management fee	$ 100,000	
Transfer agent's fee	50,000	
Other expenses	50,000	
		200,000
Investment income — net		3,000,000
Realized and unrealized gain on investments		
Net realized gain from investments	1,000,000	
Change in unrealized appreciation for the year	1,000,000	
Net gain on investments		2,000,000
Net increase in net assets resulting from operations		$ 5,000,000

Statements of Changes in Net Assets—
Years Ended December 31, 19X4
and 19X3

	19X4	19X3
Increase (decrease) in net assets —		
Operations		
Investment income — net	$ 3,000,000	$ 2,400,000
Net realized gain from investment	1,000,000	700,000
Change in unrealized appreciation	1,000,000	300,000
	5,000,000	3,400,000
Dividends to shareholders from —		
Investment income — net	(3,000,000)	(2,400,000)
Net realized gain from investments	(1,000,000)	(700,000)
Capital share transactions (Notes 6 and 7)	12,000,000	1,100,000
Total increase	13,000,000	1,400,000
Net assets		
Beginning of year	17,000,000	15,600,000
End of year	$30,000,000	$17,000,000

Exhibit 3

Notes to Financial Statements of the Combined Entity Immediately After Acquisition

Note 6—Acquisition of Fund B

On December 31, 19X4, Fund A acquired all the net assets of Fund B pursuant to a plan of reorganization approved by Fund B shareholders on December 26, 19X4. The acquisition was accomplished by a tax-free exchange of 1,000,000 shares of Fund A (valued at $10 million) for the 1,000,000 shares of Fund B outstanding on December 31, 19X4. Fund B's net assets at that data ($10 million), including $1 million of unrealized appreciation,* were combined with those of Fund A. The aggregate net assets of Funds A and B immediately before the acquisition were $20,000,000 and $10,000,000, respectively.†

Note 7—Capital Share Transactions

As of December 31, 19X4, there were 100 million shares of $1 par value capital stock authorized. Transactions in capital stock were as follows:

	Shares		*Amount*	
	19X4	*19X3*	*19X4*	*19X3*
Shares sold	500,000	300,000	$ 4,800,000	$3,000,000
Shares issued in connection with acquisition of Fund B	1,000,000		10,000,000	
Shares issued in reinvestment of dividends	300,000	250,000	3,000,000	2,400,000
	1,800,000	550,000	17,800,000	5,400,000
Shares redeemed	600,000	450,000	5,800,000	4,300,000
Net increase	1,200,000	100,000	$12,000,000	$1,100,000

* If appropriate, significant amounts of undistributed income and undistributed realized net gains or losses from investment transactions should be similarly disclosed.

† If the acquisition is completed at other than the fiscal year-end, disclosure of the combined net assets immediately after the acquisition is appropriate.

Appendix F

Illustrative Representation Letter—XYZ Management Investment Company

January 21, 19X5

Gentlemen:

In connection with your audit of the statement of assets and liabilities, including the statement of investments [*or statement of net assets*] of XYZ Management Investment Company as of December 31, 19X4, and the related statements of operations for the year then ended, changes in net assets for the two years then ended, and the selected per share data and ratios for the five years then ended for the purpose of expressing an opinion as to whether the financial statements and selected per share data and ratios present fairly the financial position, results of operations, and changes in net assets in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your audit.

1. We are responsible for the fair presentation, in the financial statements, of financial position, results of operations, changes in net assets, and selected per share data and ratios in conformity with generally accepted accounting principles.
2. We have made available to you—
   a. All financial records and related data.
   b. All minutes of the meetings of stockholders, directors, and committees of directors, or summaries or actions of recent meetings for which minutes have not yet been prepared.
3. There have been no—
   a. Irregularities involving management or employees who have significant roles in the internal control structure or that could have a material effect on the financial statements.
   b. Communications from regulatory agencies, such as the SEC and the Internal Revenue Service, concerning noncompliance with or deficiencies in financial reporting practices, law, or regulation.
4. The following have been properly recorded or disclosed in the financial statements:
   a. Related party transactions and other transactions with affiliates, including fees, commissions, purchases, and sales
   b. Arrangements with financial institutions involving compensating balances, or other arrangements involving restrictions on cash balances and line of credit or similar arrangements
   c. Capital stock repurchase options or agreements, or capital stock reserved for options, warrants, or other requirements (possibly applicable to closed-end companies)
5. There are no—

a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

b. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by Statement of Financial Accounting Standards No. 5.

c. Material transactions that have not been properly recorded in the accounting records underlying the financial statements.

6. We also advise you that to the best of our knowledge and belief—

a. Portfolio securities are stated at value as determined in accordance with the valuation method set forth in the current prospectus. All Company investments during the period were made in accordance with the investment policies stated in the current prospectus.

b. The Company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets, nor has any asset been pledged except as disclosed in the financial statements.

c. The Company complied with the provisions of the Investment Company Act of 1940 and the rules and regulations thereunder, complied with the provisions of its prospectus and the requirements of the various Blue Sky laws under which the Company operates, and qualified as a regulated investment company pursuant to subchapter M of the Internal Revenue Code. The daily net asset value has been properly computed throughout the year in accordance with rule 2a-4 of the Investment Company Act of 1940, and was correctly applied in the computation of daily capital stock sales and redemption transactions.

d. The Company did not make any commitments during the year as underwriter, nor did it engage in any transactions made on margin, in joint trading, or selling short.

e. The Company intends to continue its qualification as a regulated investment company.

f. The Company, except to the extent indicated in its financial statements, does not own any securities of persons who are directly affiliated as defined in section 2(a)(3) of the Investment Company Act of 1940.

g. There were no investments in issuers 5 percent or more of whose securities were owned by officers and directors of the Fund.

h. There are no unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with the provisions of Statement of Financial Accounting Standards No. 5.

i. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

Further, we advise you that, to the best of our knowledge and belief, the Company has not entered into any agreements not in the ordinary course of business, nor have events occurred subsequent to December 31, 19X4, that would require adjustment to, or disclosure in, the financial statements.

Very truly yours,

XYZ Management Investment Company

Chief Executive Officer

Chief Financial Officer

Appendix G

Statement of Position 89-2

Reports on Audited Financial Statements of Investment Companies

January 1989

Amendment to
AICPA Audit and Accounting Guide
Audits of Investment Companies

Prepared by the Investment Companies Committee

American Institute of
Certified Public Accountants

AICPA

NOTICE TO READERS

This statement of position presents the recommendations of the AICPA Investment Companies Committee regarding the application of generally accepted auditing standards to reports on audited financial statements of investment companies. It represents the considered opinion of the committee on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

Reports on Audited Financial Statements of Investment Companies

Introduction

1. In 1987, the audit and accounting guide *Audits of Investment Companies* was issued. Chapter 9 of that guide illustrates reports on audited financial statements. In April 1988, the AICPA's Auditing Standards Board issued Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements,* which changes the auditor's standard report on financial statements. This statement of position amends *Audits of Investment Companies* in response to the changes required by SAS No. 58; it replaces paragraphs 9.03 through 9.09 of the guide with new paragraphs 9.03 through 9.09.

9.03 The following form of auditor's report may be used to express an unqualified opinion on the financial statements:

Independent Auditor's Report

To the Shareholders and
Board of Directors
XYZ Investment Company:

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company, including the schedule of portfolio investments, as of December 31, 19X4, and the related statements of operations and cash flows[1] for the year then ended, the statement of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 19X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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[1] FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows From Certain Securities Held for Resale,* amends FASB Statement No. 95, *Statement of Cash Flows,* to exempt highly liquid companies that meet specified conditions from the requirement to provide a statement of cash flows.

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 19X4, the results of its operations and its cash flows[2] for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

Independent Auditor

Anytown, USA
January 21, 19X5

9.04 The reference to "and brokers" in the fourth sentence of the scope paragraph is not normally required if the investment company's financial statements do not show an amount payable for securities purchased. Also, if securities were "verified by examination," the report should be modified to state that.

9.05 The accountant's report for a fund referred to as a "series fund" needs to be modified because of the uniqueness of the financial statements that have evolved to present its financial position, results of operations, and cash flows. The financial position, results of operations, and cash flows of the portfolios or other entities constituting the series are frequently presented in separate columns. The financial statements of the series may also be presented as if the series were a separate entity. In both cases, the scope of the audit should be sufficient to enable the auditor to report on the individual financial statements of the various entities constituting the series fund.

9.06 The following illustration is for a multicolumnar presentation of the portfolios constituting the series:

Independent Auditor's Report

To the Shareholders and
Board of Directors
XYZ Series Investment Company:

We have audited the accompanying statements of assets and liabilities, including the schedules of investments, of XYZ Series Investment Company (comprising, respectively, the Foreign, Domestic Common Stock, Long-Term Bond, and Convertible Preferred Portfolios) as of December 31, 19X4, and the related statements of operations and cash flows[3] for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

[*Same second paragraph as in the report illustrated in paragraph 9.03.*]

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[2] See footnote 1.
[3] See footnote 1.

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of each of the respective portfolios constituting the XYZ Series Investment Company as of December 31, 19X4, the results of their operations and their cash flows[4] for the year then ended, the changes in their net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

Independent Auditor

Anytown, USA
January 21, 19X5

9.07 The following illustration is for a presentation of one of the portfolios or entities constituting the series:

Independent Auditor's Report

To the Shareholders and
Board of Directors
XYZ Series Investment Company:

We have audited the accompanying statement of assets and liabilities, including the schedule of portfolio investments, of the Convertible Preferred Portfolio (one of the portfolios constituting the XYZ Series Investment Company) as of December 31, 19X4, and the related statements of operations and cash flows[5] for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

[*Same second paragraph as in the report illustrated in paragraph 9.03.*]

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of the Convertible Preferred Portfolio of the XYZ Series Investment Company as of December 31, 19X4, and the results of its operations and cash flows[6] for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

Independent Auditor

Anytown, USA
January 21, 19X5

The auditor's reports illustrated in this paragraph and in paragraph 9.06 are not intended to be all-encompassing or necessarily illustrative of all situations that may be encountered in practice.

9.08 The auditor's report should include an explanatory paragraph when the financial statements contain securities whose values were estimated by the board of directors in the absence of readily ascertainable market values, and the range of possible values of those securities is significant. That report, as illustrated below, should be used only if the auditor concludes that, after examining the underlying documentation supporting the board's good-faith estimate of value, the valuation principles are acceptable, are being consistently applied, are reasonably supported by the documentation, and the range of possible values is significant. If the range of possible values is not significant, a report such as that illustrated in paragraph 9.03 may be issued.

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[4] See footnote 1.
[5] See footnote 1.
[6] See footnote 1.

Independent Auditor's Report

To the Shareholders and
Board of Directors
XYZ Investment Company:

[*Same first, second, and third paragraphs as in the report illustrated in paragraph 9.03.*]

As explained in Note 2, the financial statements include securities valued at $__________ (__________% of net assets), whose values have been estimated by the Board of Directors in the absence of readily ascertainable market values. We have reviewed the procedures used by the Board of Directors in arriving at its estimate of value of such securities and have inspected underlying documentation, and, in the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, those estimated values may differ significantly from the values that would have been used had a ready market for the securities existed, and the differences could be material.

Independent Auditor

Anytown, USA
January, 21, 19X5

9.09 If the auditor concludes that the valuation procedures are inadequate or unreasonable, or that the underlying documentation does not support the valuation, the auditor should express a qualified opinion as follows:

Independent Auditor's Report

To the Shareholders and
Board of Directors
XYZ Investment Company:

[*Same first and second paragraphs as in the report illustrated in paragraph 9.03.*]

As explained in Note 2, the financial statements include securities valued at $__________ (__________% of net assets), whose values have been estimated by the Board of Directors in the absence of readily ascertainable market values. We have reviewed the procedures used by the Board of Directors in arriving at its estimate of value of such securities and have inspected underlying documentation. In our opinion, those procedures are not reasonable, and the documentation is not appropriate to determine the value of the securities in conformity with generally accepted accounting principles. The effect on the financial statements of not applying adequate valuation procedures is not readily determinable.

In our opinion, except for the effects on the financial statements and selected per share data and ratios of the valuation of investment securities determined by the Board of Directors, as described in the preceding paragraph, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 19X4, the results of its operations and its cash flows[7] for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

Independent Auditor

Anytown, USA
January 21, 19X5

Effective Date

2. This statement is effective at the time of its issuance.

[7] See footnote 1.

Appendix H

Statement of Position 89–7

Report on the Internal Control Structure in Audits of Investment Companies

December 29, 1989

Amendment to
AICPA Audit and Accounting Guide
Audits of Investment Companies

Prepared by the Investment Companies Committee

American Institute of
Certified Public Accountants

AICPA

NOTICE TO READERS

This statement of position presents the recommendations of the AICPA Investment Companies Committee regarding the application of generally accepted auditing standards to reports on the internal control structure in audits of investment companies. It represents the considered opinion of the committee on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

Report on the Internal Control Structure in Audits of Investment Companies

Introduction

1. In 1987, a revised edition of the audit and accounting guide *Audits of Investment Companies* was issued. Paragraph 9.11 of that guide illustrates a report covering the review of the system of internal accounting control required as an exhibit to accompany the year-end report on Form N-SAR filed with the Securities and Exchange Commission (SEC), based on the guidance in paragraphs 47 through 53 of Statement on Auditing Standards (SAS) No. 30, *Reporting on Internal Accounting Control.*

2. In April 1988, the AICPA's Auditing Standards Board issued SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit,* which supersedes paragraphs 47 through 53 of SAS No. 30. This statement of position amends *Audits of Investment Companies* in response to the changes required by SAS No. 60; the guidance in paragraph 3 of this statement supersedes paragraph 9.11 of the guide. The revised report presented below does not change the independent auditor's responsibilities to report material weaknesses as described in the instructions to Form N-SAR.

Report on Internal Control Required by the SEC

3. The following is an illustration of the independent auditor's report on a management investment company's internal control structure based on the results of procedures performed in obtaining an understanding of the internal control structure and assessing control risk. These procedures should include the review, study, and evaluation of the accounting system, internal accounting controls, and procedures for safeguarding securities required by the instructions to Form N-SAR.

> Board of Directors
> XYZ Investment Company
>
> In planning and performing our audit of the financial statements of XYZ Investment Company for the year ended December 31, 19X1, we considered its internal control structure, including procedures for safeguarding securities, in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and to comply with the requirements of Form N-SAR, not to provide assurance on the internal control structure.
>
> The management of XYZ Investment Company is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. Two of the objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit preparation of financial statements in conformity with generally accepted accounting principles.
>
> Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that it may become inadequate because of changes in conditions or that the effectiveness of the design and operation may deteriorate.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control structure, including procedures for safeguarding securities, that we consider to be material weaknesses as defined above as of December 31, 19X1.*

This report is intended solely for the information and use of management and the Securities and Exchange Commission.

Accounting Firm
New York, New York
February 15, 19X2

Effective Date

4. This statement is effective for audits of financial statements for periods beginning on or after January 1, 1989.

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* If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of the fourth paragraph of the report should be modified as follows:

However, we noted the following matters involving the (control environment, accounting system, control procedures, or procedures for safeguarding securities) and its (their) operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the financial statements of XYZ Investment Company for the year ended December 31, 19X1, and this report does not affect our report thereon dated February 15, 19X2. [*A description of the material weaknesses that have come to the auditor's attention would follow. Also Sub-item 77B of the instructions to Form N-SAR says "(d)isclosure of a material weakness should include an indication of any corrective action taken or proposed."*]

Appendix I

Schedule of Changes Made to Audits of Investment Companies

Reference	Change	Date
General	The term "examination" has been changed to "audit" to conform to the terminology used in SAS No. 58.	October, 1990
Preface	Conformed to the terminology used in SAS No. 58.	April, 1992
Paragraph 1.05	Footnote 2 regarding a proposed Statement of Position deleted.	October, 1990
Paragraph 1.38 (footnote 12)	Note reference to FASB Statement No. 109 added.	April, 1992
Paragraph 2.84	Conformed to the terminology used in SAS No. 55.	April, 1992
Paragraph 2.115	Footnote regarding anticipated Statements on Auditing Standards deleted.	October, 1990
Paragraph 2.117	Conformed to the terminology used in SAS No. 55.	April, 1992
Paragraph 2.118	The second standard of fieldwork conformed to the current *Codification of Statements on Auditing Standards.*	October, 1990
Paragraph 2.119	Conformed to the terminology used in SAS No. 55.	April, 1992
Paragraph 2.120	Reference to SAS No. 70 added.	April, 1992
Paragraphs 2.122, 2.137, and 2.138	Conformed to the terminology used in SAS No. 55.	April, 1992
Paragraph 2.141	Reference to SAS No. 70 added.	April, 1992
Paragraph 2.146	Conformed to the terminology used in SAS No. 58.	April, 1992
Paragraph 3.25	Footnote regarding anticipated Statements on Auditing Standards deleted.	October, 1990
Paragraph 3.26	Caption conformed to the terminology used in SAS No. 55.	April, 1992
Paragraphs 3.30, 3.31, 3.33, and 3.43	Conformed to the terminology used in SAS No. 55.	April, 1992
Paragraphs 3.50, 3.52, and 3.53	Note reference to SAS No. 70 added.	April, 1992

Reference	Change	Date
Paragraph 7.24	Footnote regarding anticipated statements on Auditing Standards deleted.	October, 1990
Paragraph 9.03	Integrated from SOP 89-2; Note reference to FASB Statement No. 95 added.	October, 1990
Paragraphs 9.04 and 9.05	Integrated from SOP 89-2; Conformed to SAS No. 58.	October, 1990
Paragraphs 9.06, 9.07, 9.08, and 9.09	Integrated from SOP 89-2.	October, 1990
Paragraph 9.11	Integrated from SOP 89-7.	October, 1990
Appendix F	Conformed to the terminology used in SAS No. 55.	April, 1992
Appendix G	SOP 89-2 added.	April, 1992
Appendix H	SOP 89-7 added.	April, 1992

Glossary *

accumulation plan. An investment plan under which an investor may regularly buy specified minimum amounts of investment company shares. Dividends and distributions are usually reinvested automatically. Sometimes referred to as *a systematic plan.* (See **contractual plan.**)

accumulation unit. The basic valuation unit of a deferred variable annuity. Such units are valued daily to reflect investment performance and the prorated daily deduction for expenses.

ADR (American depository receipt). A certificate issued by an American bank to evidence ownership of original foreign shares. The certificate is transferable and can be traded. The original foreign stock certificate is deposited with a foreign branch or correspondent bank of the issuing American bank.

adviser. See **investment adviser.**

advisory and service fee (contract). The fee charged to an investment company by its investment adviser under a contract approved by vote of a majority of the company's shares. The fee is generally computed as a percentage of the average net assets, and may also provide for an additional bonus or penalty based on performance. (See **incentive compensation.**)

affiliated company. Under sections 2(a)(2) and 2(a)(3) of the Investment Company Act of 1940, a company in which there is a direct or indirect (*a*) ownership, control of or voting power over 5 percent or more of the outstanding voting shares or (*b*) control of or by, or common control under, another company or persons. (See **controlled affiliate.**)

amortized cost. A method of valuation, discussed in Rule 2a-7 of the 1940 Act, in which a portfolio security is carried at cost and interest, payable at maturity, and is accrued as income on a daily basis over the life of the instrument.

annuity contract. A contract issued by an insurance company that provides payments for a specified period, such as for a specified number of years, or for life. (See **variable annuity.**)

arbitrage. The simultaneous purchase and sale of the same (or equivalent or related) securities to take advantage of price differences prevailing in separate markets. The term is now used widely in connection with concurrent purchases and sales of securities of proposed acquiring and acquired companies in pending tender offers and other acquisitions.

asked price. A potential seller's lowest declared price for a security.

balanced fund. An investment company that invests in varying proportions from time to time in equity and fixed income securities for growth and income.

banker's acceptance. A time or sight draft drawn on a commercial bank by a borrower, usually in connection with a commercial transaction. The borrower is liable for payment, as is the bank, which is the primary obligor, to pay the draft at its face amount on the maturity date.

bid price. The highest declared price a potential buyer is willing to pay for a security at a particular time.

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* Note: Certain terms defined in the glossary but not used in the guide have been included because they are commonly used in the industry and may help the auditor.

Blue Sky laws. State laws governing the sale of securities, including mutual fund shares, and the activities of brokers and dealers within the particular state, and applicable also in interstate transactions having some substantial connection with the state.

bond discount. The difference between the face amount of a bond and the lower price paid by the buyer.

bond fund. An investment company that invests principally in bonds.

bond premium. The difference between the face amount of a bond and the higher price paid by a buyer.

book shares. Investment company share ownership evidenced by records maintained by a transfer agent rather than by physical stock certificates.

break point. A quantity of securities purchased at which a lower sales charge takes effect; also, an aggregate amount of investment company assets in excess of which a lower rate of investment advisory fee is chargeable.

broker. An agent, often himself or herself a member of a stock exchange firm or an exchange member, who executes orders to buy or sell securities or commodities and charges a commission. (See section 2(a)(b) of the 1940 Act.)

bunching. Grouping transactions in the same security for several investment clients of the same investment adviser to obtain the benefit of lower commission charges or other transaction costs.

business development company (BDC). A company defined in section (a)(48) of the Investment Company Act of 1940 as a closed-end investment company that chooses to be treated as a BDC under the Act, and is operated for the purpose of making investments in *eligible portfolio companies*, follow-on investments in former eligible portfolio companies acquired by the company when the investee was an eligible portfolio company, and investments in certain bankrupt or insolvent companies.

call option. A contract that entitles the holder to buy (call), at his or her option, a specified number of units of a particular security at a specified price at any time until the stated expiration date of the contract. The option, which is generally for a round lot amount and is transferable, is bought in the expectation of a price rise above the contract price. If the price rises, the buyer generally exercises or sells the option. If the price does not rise, the buyer lets the option expire and loses only the cost of the option. There is a listed as well as an over-the-counter market in options. During the existence of an over-the-counter option, the exercise price and underlying number of shares are adjusted on the expiration date for cash dividends, rights, and stock dividends or splits.

capital gain dividend. A net long-term capital gain distribution as defined by the Internal Revenue Code. (See section 852(b)(3)(C) of the Code.)

capital gain or loss. A profit or loss realized from the sale of capital assets, such as portfolio securities, as defined in section 1221 of the Internal Revenue Code.

capital gains distribution. A dividend paid to investment company shareholders as a result of net capital gains realized by a regulated investment company on the disposition of portfolio securities. (See section 19(b) and rules 19a-1 and 19b-1 of the 1940 Act.)

Chicago Board Options Exchange (CBOE). A national securities exchange, based in Chicago, that provides a continuous market for trading in put and call options. (Various other exchanges such as the American, Pacific, Philadelphia, and Baltimore and Washington Exchanges also provide such markets.)

certificates of deposit. Generally, short-term, interest-bearing, negotiable certificates issued by commercial banks or by savings and loan associations against funds deposited in the issuing institution.

churning. A process of executing unnecessary purchases and sales of portfolio securities to generate commissions.

clearing agency. A central location at which security transactions of members are matched to determine the minimum quantities to be received or delivered.

closed-end fund. An investment company having a fixed number of shares outstanding, which it does not stand ready to redeem. Its shares are traded similarly to those of other public corporations. (See section 5(a) of the 1940 Act.)

closed-up fund. An open-ended investment company that no longer offers its shares for sale to the general public but still stands ready to redeem its outstanding shares.

collective (common) trust fund. An account maintained by the trust department of a bank or trust company for the pooling of investment funds of its own trust account customers, exempt from the Investment Company Act under section 3(c)(3).

commercial paper. Short-term, unsecured, promissory notes issued by corporations. Commercial paper is usually sold on a discount basis. (See section 3(a)(3) of the Securities Act of 1933 and section 3(a)(10) of the Securities Exchange Act of 1934.)

contango. An interest factor reflecting the excess of the future price of a commodity contract over the spot price.

contingent deferred sales charge. A charge related to an issuer's payments for distribution pursuant to a rule 12b-1 plan. It is imposed only on redemption and may be reduced or eliminated as the duration of ownership continues.

contractual plan. A type of accumulation plan under which the total intended investment is specified with provisions for periodic payments over a stated period. Such plans are sometimes called **front-end load plans** because a substantial portion of the sales charge applicable to the total investment is usually deducted from early payments. (See sections 2(a)(27) and 27 of the 1940 Act concerning periodic purchase plans.)

control. Defined by section 2(a)(9) of the 1940 Act as the power to exercise (whether exercised or not) a controlling influence over the management or policies of a company, unless that power results solely from an official position with the company.

controlled affiliate. Defined by the 1940 Act as a direct or indirect ownership of more than 25 percent of the outstanding voting securities of a company. Such control can be disclaimed. (See **affiliated company**.)

convertible securities. Securities carrying the right (either unqualified or under stated conditions) to exchange the security for other securities of the issuer or of another issuer. Most frequently applies to preferred stocks or bonds carrying the right to exchange for given amounts of common stock.

coupon stripping. Refers to the separation of interest coupons from the corpus of a bearer bond. Before the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), bondholders could have argued that they were entitled to allocate all of their basis in the bond to the corpus and strip and sell the corpus while retaining the coupons and thus realize a substantial capital loss on the sale. Ordinary income on the coupons was reported as the coupons were redeemed. TEFRA requires bondholders to allocate their basis between the corpus and the coupons, thus making coupon stripping less attractive.

CUSIP (number). A means of uniformly describing and identifying specific security issues in numeric form. Developed by the Committee on Uniform Security Identification Procedure.

custodian. A bank, trust company, or, less frequently, a member of a national securities exchange, responsible for receiving delivery and for the safe-keeping of an investment company's cash and securities. (See section 17(f) of the 1940 Act.)

daily limits. Limits established by exchanges on fluctuations in prices of futures contracts (other than the current month's delivery contracts) during a trading session.

dealer. A person or firm acting as a principal rather than as an agent in buying and selling securities. Mutual fund shares are usually sold through dealers. (See section 2(a)(11) of the 1940 Act.)

declaration date. The day on which the board of directors or, if so authorized, a committee of the board decides on a distribution of cash or other specified assets to be paid at a specified future time to shareholders of record on a specified record date. The amount of distribution is usually specified on a per share basis, though investment company distributions are occasionally specified in an aggregate amount to assure the desired federal income tax consequence.

deemed dividend. A dividend not paid in cash or other consideration. For a regulated investment company, the term is generally used in connection with net realized long-term capital gains that are retained undistributed, in whole or in part, by the regulated investment company and on which it pays the federal income tax on behalf of shareholders as a whole. Each shareholder reports his or her share of the deemed dividend as a long-term capital gain and receives a credit against his or her federal income tax liability for his or her share of the tax paid by the regulated investment company, as well as an increase in basis of those shares. (See **designated capital gain.**)

deficiency dividend. A dividend paid by a regulated investment company to protect its special tax status on an increase in investment company taxable income, an increase in the excess of net capital gains over the deduction for capital gains dividends paid, or a decrease in the deduction for dividends paid, determined by computing the investment company's taxable income after the end of the taxable year. (See rules 19b-1(a) and 19b-1(e) of the 1940 Act.)

delayed delivery contract. A transaction for which delivery and payment are longer than the usual regular-way transaction.

depositor. A person, other than the trustee or custodian, who is primarily responsible for the organization of a unit investment trust that deposits the portfolio with (that is, sells the portfolio to) the trustee and who has certain continuing responsibilities in administering the affairs of that trust. (See sections 17(a)(1)(C) and 26 of the 1940 Act.)

designated capital gain. A term used by a regulated investment company to refer to its election to retain long-term capital gains realized during the year. (See **deemed dividend**.)

distributions. Dividends paid from net investment income and realized capital gains. (See **capital gains distribution and dividends**.)

distributor. Usually the principal underwriter who sells the mutual fund's capital shares by acting as an agent (intermediary between the fund and an independent dealer or the public) or as a principal, buying capital shares from the fund at net asset value and selling shares through dealers or to the public. (See definition of *underwriter* in section 2(a)(40) of the 1940 Act.)

diversification. Investing in more than one security issue to spread and reduce investment risks.

diversified investment company. A management investment company having at least 75 percent of its total assets in cash and cash items (including receivables), government securities, securities of other investment companies, and other securities limited to not more than 5 percent of its total assets in any one issuer and to not more than 10 percent of the voting securities of any one issuer in accordance with section 5(b)(1) of the Investment Company Act of 1940.

dividends. Pro rata payments to shareholders from net investment income and realized capital gains. (See **distributions**.)

dual purpose fund. A closed-end investment company with two classes of shares—income shares for those interested in income and capital shares for those interested in capital growth.

due bill. A document passed between brokers or dealers stating that dividends, rights to subscribe, stock dividends, and the like are the property of the holder of the due bill.

eligible portfolio company. Defined by section 2(a)(46) of the 1940 Act as any U.S. organized company that is not itself an investment company and that (1) does not have a class of securities registered on a national securities exchange or eligible for margin purchase under Federal Reserve Board rules or (2) is actively controlled by a BDC, either alone or as part of a group acting together, and has an affiliate of the BDC on its board of directors. In most instances it must be a company to which the BDC extends significant managerial assistance, either through the exercise of control or through an arrangement whereby the BDC, acting through its directors, officers, and employees, provides significant guidance and counsel concerning the management, operations, or business objectives and policies of the company.

equalization. An accounting method used to prevent a dilution of the continuing shareholders' per share equity in undistributed net investment income caused by the continuous sales and redemptions of capital shares.

equity securities. A term referring to common and preferred stocks and debentures convertible into common stocks.

eurodollar. U.S. dollars deposited in banks outside the United States.

evaluator. Determines the daily or periodic value per unit.

ex-dividend or ex-distribution. Synonym for *shares being traded without dividend or without capital gains distribution.* The buyer of a stock selling ex-dividend does not acquire a right to receive a previously declared but not-yet-paid dividend. Dividends are payable on a fixed date to shareholders recorded on the stock transfer books of the disbursing company as of a previous date of record. (See **record date.**) For example, a dividend may be declared as payable to holders of record on the books of the disbursing company on a given Friday. Because five business days are allowed for delivery of the security in regular-way transactions on a stock exchange or over-the-counter, the exchange or the NASD declares the stock ex-dividend as of the opening of the market on the preceding Monday or on one business day earlier for each intervening nontrading day. Therefore, anyone buying the stock on and after Monday is not entitled to the dividend. In the case of nontraded shares of mutual funds, the ex-dividend date is the same as the record date.

exempt securities. Securities exempted from registration under the provisions of the Securities Act of 1933 or the Securities Exchange Act of 1934, other than by action of the SEC.

expense limitation. A contractual provision between an investment company and its investment adviser, in which the adviser agrees to limit its advisory fee or the total expenses of the company to an amount that is usually based on a stipulated relationship between total expenses and average net assets. An expense limitation may also be a similar limitation on the investment advisory fee imposed by a Blue Sky statute of a state in which the investment company's shares are sold.

ex-rights. Similar to ex-dividend. The buyer of a stock selling ex-rights is not entitled to a rights distribution.

ex-warrants. Stocks or bonds trading without attached warrants, entitling holders to subscribe to additional shares within specified periods and at specified prices.

face amount certificate company. An investment company, as defined by section 28 of the 1940 Act, that issues installment-type certificates as defined by section 2(a)(15) of the 1940 Act.

fail to deliver. Securities that the selling broker or other financial institution has not delivered to the buyer at the settlement or clearance date.

fail to receive. Securities that the buying broker or a financial institution has not received from the seller at the settlement or clearance date.

fair value. An estimated value determined in good faith by the board of directors under the Investment Company Act of 1940 for securities and assets and having no readily available market quotation. (See section 2(a)(41).)

financial reporting releases. The SEC's published views and interpretations on matters dealing with financial reporting, auditing, and independence. The publications supplement the rules in Regulations S-X and S-K.

fixed income security. A preferred stock or debt security with a stated percentage or dollar income return.

flat. A method of trading in certain types of bonds, usually income bonds that do not pay interest unless it has been earned and declared payable or bonds on which the issuing corporation has defaulted in paying interest. The seller of a bond trading flat is not entitled to receive the interest that has accrued since the date of the last interest payment and delivers the bond with all unpaid coupons attached or a due bill authorizing the buyer to collect interest, if any, which may be paid by the issuing corporation in the future.

forward exchange contract. An agreement to exchange currencies of different countries at a specified future date at a specified rate (the forward rate). Unlike a securities futures contract, the terms of a forward contract are not standardized.

forward placement commitment contract. An over-the-counter contract for delayed delivery of securities in which the buyer agrees to buy and the seller agrees to deliver a specified security at a specified price at a specified future date.

forward pricing. The pricing of mutual fund shares for sale, repurchase, or redemption at a price next computed after an order has been received. Mutual fund shares are usually priced once or twice a day.

fractional share. A portion of a full share of stock.

front-end load plan. See **contractual plan.**

futures contract. A transferable agreement to deliver or receive during a specific future month a standardized amount of a commodity of standardized minimum grade or a financial instrument of standardized specification under terms and conditions established by the federally designated contract market.

growth fund. An investment company investing primarily or entirely in growth industry securities, emphasizing future capital appreciation over current yield.

growth stock. The stock of a company whose earnings are expected to increase and to result in raising the market value of the stock. Growth stock companies generally reinvest a substantial amount of their earnings rather than pay them out in cash dividends.

guaranteed securities. Bonds or stocks for which payment of interest or dividends is guaranteed by a company other than the issuing company. The guarantee for bonds may also include the payment of principal.

handshake date. The date on which a price and other general terms are determined, usually used for restricted securities acquired by an investment company.

hedge fund. An investment company seeking to minimize market risks by holding securities believed likely to increase in value and at the same time being short in securities believed likely to decrease in value. The only objective is capital appreciation.

hedging. A means of risk protection against extensive loss due to adverse price fluctuations by buying or selling a futures contract or option to offset a present or anticipated position or transaction in the cash market.

holder of record. The party listed as the registered owner on the transfer records of a corporation.

inadvertent investment company. An industrial or service company deemed to be an investment company because it inadvertently meets the criteria of section 3(a) of the Investment Company Act of 1940 and must register under that act and comply with its provisions.

incentive compensation. A fee paid to an investment company's adviser that generally consists of a basic fee plus a bonus (or less a penalty) if the fund's performance exceeds (or fails to match) that of a specified stock index. (See section 205 of the Investment Advisers Act of 1940.)

income fund. An investment company whose prime aim is to maximize income and that invests substantially in high-yield common and preferred stocks and debt securities.

initial margin deposit. A commodity transaction term, meaning the amount of money or its equivalent, specified by the commodity exchange under which the contract is traded, that is held as a good faith deposit to make sure that the customer meets the variation margin requirement. *Maintenance margin* refers to additional deposits. (See **margin**, a securities transaction term.)

interest method. A method of amortizing discount or premium on debt that results in a constant rate of interest on the sum of the face amount of debt and the unamortized premium or discount at the beginning of each period.

interested person. Under section 2(a)(19) of the 1940 Act, a person affiliated with an investment company; a member of his or her immediate family (as defined); a person affiliated with the company's investment adviser or principal underwriter; an investment company's legal counsel; any broker or dealer or its affiliated persons; and any other person as so determined administratively by the SEC based on relationships.

investment adviser (manager). Under section 2(a)(20) of the 1940 Act, a company providing investment advice, research, and often administrative and similar services for a contractually agreed-on fee, generally based on a percentage of net assets.

Investment Advisers Act of 1940. Provides for the registration and regulation of most persons who render investment advice to individuals or institutions, including investment companies, for compensation.

investment advisory agreement. An agreement between an investment company and an investment manager, engaging the investment manager to provide investment advice to the investment company for a fee. (See sections 15(a), 15(c), and 36(b) of the 1940 Act.)

investment company.* A company, as defined in section 3(a) of the Investment Company Act of 1940, primarily investing, reinvesting, or trading in securities (section 3(a)(1)), issuing face-amount certificates (section 3(a)(2)), or engaged in investing and owning investment securities, other than government securities, that have a value exceeding 40 percent of the company's total assets (section 3(a)(3)), with some exceptions to the latter (stated in section 3(b)).

Investment Company Act of 1940. Provides for the registration and regulation of investment companies.

investment company trade associations. Such associations as the Investment Company Institute (ICI), the No-Load Mutual Fund Association, the National Association of Small Business Investment Companies (NASBIC), and the Association of Publicly Traded Investment Funds (composed of closed-end companies).

investment partnership. A partnership, usually a limited partnership, organized under state law to invest and trade in securities.

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* The term, as used in this guide, also refers to investment companies that are not registered under the Investment Company Act of 1940.

letter of intent. An agreement by which a shareholder agrees to buy a specified dollar amount of mutual fund shares, usually over thirteen months, in return for a reduction in the sales charge applicable to a comparable lump sum purchase.

letter stock. See **restricted security**.

listed security. A security listed and traded on a stock exchange.

load. See **sales charge**.

long. Denotes ownership or right to possession of securities.

management (investment) company. Under section 4(3) of the Investment Company Act of 1940, any investment company, other than a face amount certificate company (as defined in section 4(1)) or a unit investment trust (as defined in section 4(2)). Management company is sometimes used to refer to the investment adviser of an investment company.

management fee. An amount charged by an investment adviser under a contract approved by the holders of a majority of the investment company's outstanding shares. The fee is generally computed as a fixed or reducing percentage of the average net assets and may also provide for an additional bonus (or penalty) based on performance. (See **incentive compensation**.)

margin. A securities transaction term, meaning the amount of money or its equivalent, specified by the Board of Governors of the Federal Reserve System, that a customer must deposit with a broker in a securities transaction on margin. (See **initial margin deposit**, a commodity transaction term.)

margin accounts. A means of leveraging offered by security brokers or dealers to permit their customers to buy securities in part with borrowed funds. The difference between the price of a security and equity provided by the customer is loaned by the broker or dealer to the customer.

mark to market. A procedure to adjust the carrying value of a security, option, or futures contract to current value.

market price. Usually the last reported price at which a security has been sold, or if the security was not traded or if trading prices are not reported, a price arrived at based on recent bid and asked prices.

matrix pricing. A statistical technique used to value normal institutional size trading units of debt securities without relying exclusively on quoted prices. Factors such as the issue's coupon or stated interest rate, maturity, rating, and quoted prices of similar issues are considered in developing the issue's current market yield. (See **fair value**.)

money market fund. A mutual fund whose investments are primarily or exclusively in short-term debt securities designed to maximize current income with liquidity and capital preservation, usually maintaining per share net asset value at a constant amount, such as one dollar.

municipal bond fund. An investment company whose shares represent holdings solely or largely of securities on which interest is exempt from federal income taxes.

mutual fund. The popular name for an open-end management investment company. (See **open-end investment company**.)

NASD (National Association of Securities Dealers, Inc.). An association of brokers or dealers, registered as such under section 15A of the Securities Exchange Act, that supervises and regulates trading conducted by its members who do business in the over-the-counter market.

NASDAQ. An electronic quotation system for over-the-counter securities sponsored by the NASD, which, in the case of securities traded on the NASD National Market System, reports prices and shares or units of securities trades in addition to other reported market information.

net assets. The term used by an investment company to designate the excess of the value of securities owned, cash, receivables, and other assets over the liabilities of the company.

net asset value per share. The value per share of outstanding capital stock of an investment company, computed (usually daily by mutual funds) by dividing net assets by the total number of shares outstanding. (See rule 2a-4 of the Investment Company Act of 1940.)

no-load fund. A mutual fund selling its shares at net asset value without adding sales charges, although some such funds have rule 12b-1 plans permitting payment of distribution expenses with fund assets, with an effect similar to that of a deferred sales load over a period subsequent to sale of shares. Investors generally deal directly with the fund, not through an investment dealer or broker.

nominee. An entity, usually a partnership, in whose name a security may be registered. That entity is not the true owner. (See **street name**.)

nondiversified investment company. A management investment company other than a diversified company, as defined in section 5(b) of the Investment Company Act of 1940.

odd lot. Usually a quantity of securities that is less than an even 100 shares or less than the established trading unit of that security in a particular securities market.

offering price. The price at which mutual fund shares or investment trust units can be bought, often equaling net asset value plus a load.

offshore fund. An investment company organized outside the United States, whose shares are offered solely to foreign investors.

open contract. An unperformed or unsettled contract. May be used in referring to new issues traded "when, as, and if issued" or in referring to commodity futures trading. The term is used to designate contracts that have been bought or sold, are still outstanding, or have been delivered or offset.

open-end investment company. A mutual fund that is ready to redeem its shares at any time and that usually offers its shares for sale to the public continuously. (See section 5(a)(1) of the Investment Company Act of 1940.)

optional dividend. A dividend payable in either stock or cash at the option of the holder of record.

original issue discount. A federal income tax term for interest to the holder of a bond that represents the difference between the face amount of a bond and its original sales price.

OTC (over-the-counter). A market for securities of companies not listed on a stock exchange and traded mainly by electronic communications such as NASDAQ or by phone between brokers and dealers who act as principals or brokers for customers and who may or may not be members of a securities exchange. The over-the-counter market is the principal market for U.S. government bonds and municipal securities.

passed dividend. (Sometimes called an *omitted dividend.*) A regular dividend that has not been declared by the directors of a corporation.

payable date. The date on which a dividend is payable to holders of record on some previous record date.

P.E. ratio. Abbreviation for *price earnings ratio.* The market value of a share of stock divided by its earnings per share.

performance fee. See **incentive compensation**.

periodic payment plan. See **accumulation plan** and sections 2(a)(27) and 27 of the Investment Company Act of 1940.

personal holding company. An income tax term, generally defined as a corporation of which 60 percent of adjusted ordinary gross income is personal holding company income, as defined in the Internal Revenue Code, and more than 50 percent in value of its outstanding stock is owned by five or fewer individuals during the last half of the taxable year.

pink sheets. A listing of over-the-counter securities published on pink paper by the National Quotation Bureau. It shows the most recent bid and asked prices for the securities listed, as well as the brokers and dealers making a market in those securities. Though pink paper is used for stock quotations, the term also applies to listings of bond quotations and the like, which are printed on papers of different color.

point. A rise or decline of one dollar per share, used to refer to the purchase or sale of stocks. If used for the purchase or sale of bonds, the term means a rise or decline of $10 per $1000 principal amount. A basis point is one hundredth of one percent of the principal amount.

portfolio. Securities owned by an investment company or other investor in securities.

portfolio turnover rate. A measure of portfolio activity, generally calculated for an investment company by dividing the lesser of purchases or sales of securities, excluding securities having maturity dates at acquisition of one year or less, by the average value of the portfolio securities held during the period. (See Form N-SAR, instructions to item 11, and Forms N-1A and N-2, in both cases in item 3, instruction 12.)

premium on redemptions (repurchases). See **redemption (repurchase) fee (or charge.)**

price make-up sheet. A detailed computation of the net asset value of a mutual fund.

principal. A person, especially a dealer, who buys or sells securities for his or her own account. Also refers to the face amount of a security without accrued interest.

principal underwriter. See distributor and definition of *underwriter* in section 2(a)(40) of the Investment Company Act of 1940.

private placement. The direct sale of a block of securities of a new or secondary issue to a single investor or group of investors. The sale or placement is usually made through an investment banker and the securities' public resale restricted if they are not registered under the Securities Act of 1933. (See **restricted security**.)

prospectus. A circular required by the Securities Act of 1933 describing securities being offered for sale to the public. (See section 2(a)(31) of the Investment Company Act of 1940.)

proxy. A person authorized to vote the shares of an absent shareholder at a meeting of shareholders. Also refers to the written authorization given to that person. (See section 20(a) of the Investment Company Act of 1940.)

proxy statement. A publication sent to stockholders by a board of directors, or its adversaries, or others, usually containing financial reports (for merger and other financial proposals), stockholders' meeting notices, and voting information on certain matters to solicit proxies from the holders. (See rules 20a-1, 20a-2, and 20a-3 under the Investment Company Act of 1940, and regulation 14A under the Securities Exchange Act of 1934.)

put option. A contract entitling the holder to sell (put), entirely at his or her option, a specified number of shares or units of a particular security at a specified price at any time until the contract's stated expiration date. The option, which is generally for a round lot and is transferable, is bought expecting the price to decline below the contract price. If the price declines, the buyer generally exercises or sells the option. If the price does not decline, the buyer lets the option expire and loses only the cost of the option. There are both listed and over-the-counter markets in options. The exercise price and number of shares of an over-the-counter option are adjusted on the ex-date for cash dividends, rights, and stock dividends or splits.

realized gain or loss. See **capital gain or loss.**

record-keeping agent. An outside service bureau, bank, or other agency engaged by an investment company to maintain records of purchases and sales of investments, sales and redemptions of fund shares, and shareholders' account statements.

record date. The date on which an owner of a share of stock must be registered on the books of a company as a shareholder to receive a declared dividend or, among other things, to vote on company affairs.

redemption. A stockholder's tender of investment company shares to the company or person designated by the company, requiring liquidation of such shares in exchange for proceeds, usually in cash, representing the net asset value of the shares tendered, occasionally less a *redemption fee.* (See section 2(a)(32) of the Investment Company Act of 1940.)

redemption in kind. Redemption of investment company shares by payment in portfolio securities, not cash. Permissible in certain circumstances for many mutual funds and tax-free exchange funds. (See rule 18f-1 under the Investment Company Act of 1940.)

redemption or repurchase price. The price, generally net asset value, occasionally less a redemption fee, at which a share of a mutual fund is redeemed or repurchased. (See section 2(a)(32) of the 1940 Act.) The term is used in paragraph 3.07.

redemption (repurchase) fee (or charge). A percentage of net asset value that may be charged to the investor on redemptions or repurchases of an open-end investment company's shares. (See section 10(d)(4) of the Investment Company Act of 1940.)

registered bond. A long-term debt instrument registered on the books of the issuing company in the owner's name, sometimes a *debenture,* if unsecured, or a *note* if short- or intermediate-term.

registered investment company. An investment company that has filed a registration statement with the SEC as an investment company in accordance with requirements of the Investment Company Act of 1940.

registered owner. The owner of a security whose name is recorded on the face of the certificate and on the books of the issuing corporation or its agent.

registrar. Usually a banking institution that countersigns stock certificates and is responsible for preventing the issuance of more stock than that authorized by the board of directors and the charter of the issuing company. (See **transfer agent**.)

registration of transfer. Usually refers to the act of recording a transfer of ownership of registered securities on the transfer books of the issuing corporation, and issuing new certificates to the new registered owner. It is not part of the transfer itself. (See **transfer**.)

regular-way transaction. Delivery of securities (other than U.S. government) and payment to the buying broker or dealer by the selling broker or dealer on the fifth business day after the transaction, unless otherwise specified. The delivery day for government bonds is the first business day following the transaction.

regulated investment company. An investment company that qualifies for the special tax treatment provided for by subchapter M of the Internal Revenue Code.

Regulation S-X. Accounting rules for form and content of financial statements and schedules required under the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1940, and the Energy Policy and Conservation Act of 1975. Article 6 applies to financial statements, and specified rules in article 12 apply to financial schedules, of investment companies.

releases. Papers issued by the SEC under each of the acts it administers.

repurchase. Liquidation of investment company shares through a principal underwriter or a broker-dealer on behalf of shareholders, sometimes for a purchase or service charge or a brokerage commission.

repurchase agreement. An agreement under which an investment company pays for and receives (*purchases*) securities from a *seller* who agrees to repurchase them within a specified time at a specified price. A repurchase agreement is known on the side of a selling broker-dealer or other seller as a reverse repurchase agreement.

restricted security. A portfolio security that may be sold privately, but that is required to be registered with the SEC or to be exempted from such registration before it may be sold in a public distribution. A private placement stock is frequently referred to as *letter stock*.

return. See **yield**.

reverse repurchase agreement. An agreement under which the investment company transfers (*sells*) securities for cash to another party (*purchaser*), usually a broker, and agrees to repurchase them within a specified time at a specified price. A reverse repurchase agreement is known in the broker-dealer industry as a repurchase agreement.

reverse split. A pro rata combination of shares into a smaller number. Opposite of stock split.

right. A privilege offered by a corporation to its shareholders pro rata to subscribe to a certain security at a specified price.

right of accumulation. A method permitting aggregation of shares being acquired with shares previously acquired and currently owned to qualify for a quantity discount that reduces the sales charge on a single purchase.

round lot. A unit of trading or a multiple of it. On the New York Stock Exchange the unit of trading is generally 100 shares in stocks and $1000 par value in bonds.

round turn. A purchase and a subsequent sale or a sale and a subsequent purchase of a futures contract.

rule 12b-1. A rule under section 12 of the Investment Company Act of 1940 that permits the use of a fund's assets to pay distribution-related expenses under conditions prescribed therein.

sale against the box. Similar to a short sale, except that the seller already owns the stock being sold but keeps possession of it and therefore has to borrow the equivalent stock to deliver to the purchaser.

sales charge. An amount providing for the underwriter's and dealer's commission that is generally added to the net asset value of an open-end investment company's shares in computing the offering price; generally, stated as a percentage of the offering price. A sales charge can also be imposed on redemption.

scrip. A certificate issued to a corporation's stockholders, which may be exchanged by a fixed date for fractional shares of stock or equivalent cash. Usually issued with a stock dividend or a stock split.

Securities Act of 1933. Regulates the contents of prospectuses and similar documents and is intended to assure that potential investors receive adequate information to make reasonably informed investment decisions.

Securities and Exchange Commission (SEC). An agency established by Congress to administer federal securities laws.

Securities Exchange Act of 1934. Regulates securities brokers and dealers, stock exchanges, and the trading of securities in the securities markets.

seed money. An initial amount of capital contributed to a company at its inception. (See section 14(a) of the Investment Company Act of 1940.)

seller's option. A transaction that by agreement is to be settled at a date later than the usual regular-way transaction.

self-issued security. A term used in connection with stock index contracts to indicate that an instrument is an investment in the entity writing the option (for example, an exchange), in contrast to a narrow-based stock index instrument, which is considered to be an investment in each of the underlying securities constituting the index.

selling group. A group of brokers or dealers that have formed several accounts for the sale of securities, usually for an underwriting.

separate account. An account established and maintained by an insurance company that holds particular assets allocated to that account, and is credited or charged with income, gains, or losses from these assets separately from income, gains, or losses of the insurance company's corporate or other accounts. Sometimes referred to as a *variable account*, a separate account funds variable annuities or variable life insurance policies. Even though it is not an entity but is only an account within the insurance company, it may be an investment company within the meaning of the 1940 Act. (See section 2(a)(37) of the Investment Company Act of 1940.)

series fund. An investment company that offers multiple segregated portfolios and classes of common stock. (See rule 6-03(j) of Regulation S-X.)

settlement date. The date on which security transactions are settled by delivering or receiving securities and receiving or paying cash pursuant to an earlier agreement of purchase and sale called a *trade*. (See **trade date**.)

short. A stock record position representing the physical location of a security (such as box, transfer, and so forth), or meaning that the security is due from others (such as failed-to-receive, or owed to the brokerage concern by a customer on account of a short sale).

short sale. A sale of securities not owned at the time of sale anticipating the price to fall and the securities to be repurchased at a profit. A person selling short borrows equivalent securities to deliver to the buyer and eventually buys the securities to return to the lender.

SIPC (Securities Investor Protection Corporation). A federal corporation established under the Securities Investor Protection Act that provides insurance against loss by customers of brokers or dealers who are in financial difficulty.

Small Business Administration (SBA). An agency established by Congress to administer the Small Business Investment Company Act of 1958.

Small Business Incentive Act of 1980. Amends the Investment Company Act of 1940 by, among other things, allowing closed-end companies to elect to be regulated as business development companies under the newly enacted section 2(a)(48) and sections 54-65 of the 1940 Act. (See **business development company**.)

Small Business Investment Act of 1958. Authorizes the SBA to provide government funds to small business investment companies licensed under that act.

small business investment company (SBIC). An investment company, registered under the Small Business Investment Company Act of 1958, that is established to provide capital to small business enterprises.

spot commodity. A contract for the delivery of a commodity. The commodity is evidenced by a warehouse receipt.

spread. A combination of a put and call option at different prices, one below and the other above the current market price. Also refers to the difference between the bid and asked prices of a security and to the dealer's commission on a security offering.

standby commitment. An agreement to accept future delivery of a security at a guaranteed price of fixed yield on exercise of an option held by the other party to the agreement.

stock dividend. A dividend payable in the stock of the issuing corporation.

stock split. An increase in the number of outstanding shares of a company's stock to decrease the market price and thus allow for greater distribution of the shares. For example, ownership of two shares for each share previously held tends to reduce the price of each share by approximately half, assuming no other concurrent changes, such as in the rate of dividend.

stockholder of record. A stockholder whose name is registered on the stock transfer books of the issuing corporation.

stop order. An order used by a customer to protect a paper profit in a security or to keep down a possible loss in a security. The stop order becomes a market order when the price of the security reaches or sells through the price specified by the customer. Also called a *stop loss order*.

straddle. A combination of one put and one call option, identical to the security issue, number of shares, exercise price, and expiration date.

strap. A combination of two call options and one put option for the same security issue.

street name. Securities held in the name of a brokerage concern (a type of nominee) instead of in customers' names. (See **nominee**.)

strip. A combination of two put options and one call option for the same security issue.

swap fund. See **tax-free exchange fund**.

syndicate. A group of brokers or dealers who together underwrite and distribute new issues of securities or large blocks of an outstanding issue.

tax-exempt fund. See **municipal bond fund**.

tax-free exchange fund. An investment company organized between 1960 and 1967 to allow investors who are holding individual securities selling at appreciated prices to exchange such securities, without payment of capital gains tax, for shares of the fund. Unless new legislation is enacted by Congress, no additional funds of this type can be created.

tender offer. A public offer to buy from stockholders not less than a specified number of shares of stock at a fixed price, usually in an attempt to gain control of the issuing company.

ticker. An instrument that prints the price and quantity of a security traded on an exchange within minutes after the trade has been executed.

trade. An agreement of purchase and sale in a securities market, to be settled or performed by payment and delivery on a later settlement date.

trade date. The date a security transaction is actually entered into, to be settled on a later settlement date.

trading unit. The unit by which the security is traded on the exchange, usually one hundred shares of stock or $1000 principal amount of bonds. Also called a **round lot**.

transfer. A change of ownership of a security by delivery of certificates for the security in a sale (against payment of the purchase price in a securities market sale), or by gift, pledge, or other disposition. A subsequent registration of the transfer in the securities transfer records of the issuer is not a part of the transfer itself.

transfer agent. An agent who keeps records of the names of the company's registered shareholders, their addresses, and the number of shares they own. The agent must be sure that certificates presented to the office for transfer are canceled and that new certificates are issued in the name of the transferee. (See **registrar**.)

undertaking. An agreement between a registrant and the SEC staff (or Blue Sky administrator) in connection with the filing of a registration statement, whereby the registrant agrees to take a future action requested by the staff but not otherwise necessarily or expressly required by the securities' statutes, but (in a federal registration) that may be required by SEC rules, or by SEC forms that have the same legal status as the rules by which they were adopted.

underwriting. The act of distributing a new issue of securities or a large block of issued securities—that is, a secondary offering, commonly including an obligation to purchase the underwritten securities, regardless of whether they can be resold to others.

unit investment trust. An investment company, organized under a trust indenture, that issues only redeemable securities, each of which represents an undivided interest in a unit of specified (usually unmanaged) securities. (See section 26 of the Investment Company Act of 1940.)

unlisted security. A security that is not listed on a securities exchange. (See **over-the-counter**.)

unrealized appreciation or depreciation. The excess (appreciation) or deficiency (depreciation) of the value of securities over (under) their cost.

unregistered securities. Securities that are not registered under the 1933 Act.

value. The market price or fair value of securities. (See **fair value**. See also rule 2a-4 of the Investment Act of 1940.)

variable annuity. An annuity having a provision for the accumulation of an account value, for benefit payments, or both, that vary according to the investment experience of the separate account to which the amounts paid for the annuity are allocated.

variation margin. A term used in commodity operations. Refers to last-day point fluctuation—a difference between the settling price of the day before and the last day's settling price—on net positions long and short.

venture capital investment company. A closed-end investment company whose primary investment objective is capital growth and whose capital is usually invested wholly or largely in restricted securities in negotiated transactions to form or develop companies with new ideas, products, or processes.

warrant. A type of option to purchase additional securities from the issuer. Commonly affixed to the certificates for other securities at the time when the combined securities units are originally issued, and usually separable, sometimes on and after a subsequent date. Also, a document evidencing options to purchase shares. For example, a warrant to purchase 125 shares.

wash sale. A sale of stock or other securities in which a taxpayer has acquired or entered a contract or option to acquire substantially identical stock or other securities within a period beginning thirty days before and ending thirty days after the date of the sale (a sixty-one day period). A loss resulting from such a sale is not deductible for federal income tax purposes, but a gain is taxable. (See section 1091 of Internal Revenue Code.)

when-distributed. Refers to the distribution of new securities, transactions for which are sometimes entered into before the securities are distributed.

when-issued. A short form for *when, as, and if issued*. The term indicates a conditional transaction in a security authorized for issuance but not yet actually issued. All such transactions are settled if and when the actual security is issued and the exchange or National Association of Securities Dealers rules that the transactions are to be settled.

yield. The return on investment that an investor receives from dividends or interest expressed as a percentage of the current market price of the security or, if the investor already owns the security, of the price paid. The return on stocks is usually computed by dividing the total dividends paid in the past calendar year by the price of the stock. The return on bonds is computed by dividing the interest by the price of the bond.

yield to maturity. The rate of return on a debt security held to maturity, giving effect to the stated interest rate, accrual of discount, and amortization of premium.

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